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SELECTED CURRENT DEVELOPMENTS IN SUBCHAPTER C

Donald V. Moorehead

In recent years, reviews of so-called current developments in almost every area of Federal taxation have increasingly focused upon the results of the latest and now almost annual Congressional exercise in substantive tax reform legislation. 1984 has proved to be no exception. Indeed, the Tax Reform Act of 1984¹ has been described by one commentator as a "gargantuan legislative product . . . which closely rivals the 1954 legislation in its scope, significance, and complexity, and clearly outstrips other major Code revisions in the intervening years."² This review of current Subchapter C developments will of necessity follow "precedent" and concentrate principally upon selected provisions of the Tax Reform Act of 1984, although brief reference will be made to several non-legislative developments which appear to have general significance.

There is also "precedent" for reviews of this type to focus upon events that have already occurred. However, given the not insubstantial likelihood of significant tax legislation in 1985 or 1986, it seems appropriate also to speculate about possible future legislative changes affecting Subchapter C. In 1983, the staff of the Senate Finance Committee issued a report proposing a comprehensive revision of Subchapter C.³ Portions of the staff recommendations were adopted in 1984, but the remaining recommendations constitute a significant unfinished agenda which may be seriously considered as part of a larger tax reform and/or deficit reduction act.

I.

Tax Reform Act of 1984

A. General Observations

The Tax Reform Act of 1984, actually but one title of the even more imposing Deficit Reduction Act of 1984, is the product of Congress' efforts to raise revenue without raising taxes. This was accomplished by the enactment of a seemingly endless series of tax provisions aimed at selectively broadening the individual and corporate income tax base through closing so-called "loopholes," reducing so-called "tax expenditures" and adopting so-called "reforms."

¹ Pub. L. 98-369.

² Eustice, *The Tax Reform Act of 1984, A Selective Analysis*, 1-1 (Warren, Gorham & Lamont 1984).

³ "Preliminary Report On The Reform And Simplification Of The Income Taxation Of Corporations" (Committee Print, September 1983).

Before turning to the Subchapter C provisions included in the 1984 Act, one should note that the Act contains numerous other provisions affecting corporations and corporate transactions. For example, Section 60 of the Act modifies the definition of "affiliated group" for purposes of defining which corporations may or may not be included in a consolidated return. Under the Act, the definition of "affiliated group" now generally requires the ownership of stock representing not only 80 percent of voting power (as under prior law) but also of total value of all classes of stock. The apparent purpose of this change was to prevent the decision to include or not include a corporation in a consolidated return from being unduly discretionary. These new rules require careful study by corporations with complex capital structures—such as convertible preferred stock—since the new rules, subject to certain transitional provisions, apply to existing affiliated groups.

In addition, Section 59 of the Act generally requires that gain be recognized by a corporation when it exchanges shares of its stock for debt and the principal amount of the debt exceeds the value of the stock. Moreover, Section 67 of the Act imposes special tax penalties upon payments under so-called "golden parachute" contracts. This provision may have an impact extending beyond the well-publicized severance packages for senior management that accompanied several large acquisitions in recent years. For example, concern has been expressed that one may encounter the "golden parachute" penalties where an employment contract provides that pension and other benefits a key employee would otherwise receive are accelerated upon a change in corporate control. There is some helpful language on this point in the Conference Report on the 1984 Act but those who use employment contracts, buy-sell agreements and the like would do well to review this provision in some detail.

These and other non-Subchapter C provisions are beyond the scope of this review, but they merit careful attention by those concerned with corporate taxation.

B. Appreciated Property Distributions

Within the confines of Subchapter C, the decision of Congress to impose a corporate level income tax on most non-liquidating distributions of appreciated property is perhaps the most far reaching of the 1984 Act changes. For years, a major tenet of Subchapter C was that corporations generally do not recognize taxable gain when they make distributions of appreciated property. This notion, premised on the Supreme Court's 1935 decision in the *General Utilities* case,⁴ is embodied in Section 311(a) of the Code with respect to non-liquidating distributions and in Section 336 with respect to liquidating distributions.

Despite this long history, Congress has in recent years, starting in 1969,

⁴ *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

imposed limitations on the general principle of nonrecognition in non-liquidation situations, and the 1983 Senate Finance Committee staff report recommended an across-the-board repeal of the *General Utilities* principle for both liquidating and non-liquidating distributions. The basic rationale for this recommendation appears to have been to preserve the integrity of the corporate income tax in a two-tier income tax structure by taxing gain whenever assets pass from the distributing corporation, particularly when the recipients obtain a new stepped-up tax basis in the distributed assets. The Finance Committee staff report also noted that, if *General Utilities* was completely repealed, the inordinately complex collapsible corporation rules of Section 341 of the Code could also be repealed for domestic corporations.

The 1984 Act does not go as far as the Finance Committee staff had recommended, but Section 54 of the Act does in effect repeal *General Utilities* with respect to most non-liquidating distributions of appreciated property. Generally, this rule applies to distributions declared after June 14, 1984. As a result, and subject to but a few narrowly drawn exceptions, corporations which make non-liquidating distributions of appreciated property generally will be taxed as if they had sold the distributed property for its fair market value at the date of distribution.

The well-publicized situation with respect to so-called "royalty trusts" in the oil and gas industry undoubtedly contributed to Congress' decision to make this selective revision to Subchapter C. It should not go wholly unnoticed that the revenue gains from such changes, however modest in isolation, contributed to the \$50 billion revenue target that was the principal impetus for the 1984 Act.

Significantly, starting in 1985, this new recognition of income rule will generally apply even where the recipient is a corporation which owns 80 percent or more of the stock of the distributing corporation. This appears to be true even if the recipient corporation would not have obtained a stepped-up basis in the assets distributed to it, presumably on the theory that deferral of the corporate income tax in such cases would be inappropriate. Both the House and Senate versions of the 1984 Act would have taxed non-liquidating appreciated property distributions to corporate shareholders if the corporate recipient owned less than 80 percent of the stock of the distributing corporation. The Conference Committee expanded this provision to cover all corporate recipients. An exemption in the 80 percent or more situation was considered inappropriate apparently because the subsidiary could shift its tax liability to its parent corporation and the parent then might be able to convert ordinary income into capital gains on the subsequent sale of the asset. In such cases, however, the current consolidated return regulations⁵ appear to shield the subsidiary from immediate taxation as a deferred intercompany transaction, although the legislative history of 1984 Act suggests that consideration be given to changing the regulations.

⁵ Reg. 1.1502-14.

It should be noted that the new income recognition rule does not apply in those cases where the distribution is not governed by sections 301-307 of the Code. For example, if a corporation distributes to its shareholders the appreciated stock of its wholly-owned subsidiary in a spin-off which qualifies under Section 355 of the Code, the distributing corporation does not recognize taxable gain. In contrast, where the non-liquidating distribution is taxed under Section 301 or Section 302, either directly, or indirectly under the rules of Section 304, which applies to redemptions and other similar transactions involving commonly controlled corporations, recognition by the distributing corporation is generally required even if the recipient is a corporation. If the recipient is not a corporation, this general rule is subject to narrow exceptions which generally are applicable only to shareholders who have owned at least 10 percent in value of the corporation's stock for at least five years.

In short, the 1984 Act, motivated in large part by the search for revenue, embodies what has been described as "a further nail in the coffin of the *General Utilities* doctrine." This provision of the 1984 Act merits careful study in its own right and counsels concern that in 1985 or 1986 Congress will seriously consider and possibly take action effectively to repeal Section 336 of the Code so that the recognition principle will apply to all corporate distributions of appreciated property, including liquidating distributions.

In its very recent report to the President on tax reform,⁶ the Department of the Treasury recommended the partial integration of the corporate and individual income taxes by allowing corporations to deduct a portion of the dividends paid out of previously taxed earnings. If this proposal is pursued seriously by Congress, interesting questions with respect to the *General Utilities* doctrine will arise. At present, it appears uncertain how the notion of taxing appreciating property distributions will be squared with concept of ameliorating the current double taxation of corporate income.

C. Earnings and Profits.

The 1984 Act also makes changes to the definition of "earnings and profits." Under present law, this definition is significant principally because it limits the extent to which corporate distributions are taxed as dividends. In its 1983 study, the staff of the Senate Finance Committee recommended repeal of this limitation. The Treasury Department opposed such an approach in part on Constitutional grounds, and Congress responded in Section 61 of the 1984 Act with a more narrowly drawn provision requiring a series of new adjustments having as their common denominator the desire to equate the tax concept of "earnings and profits" more nearly with corporate economic income.

While some of the new adjustments are rather narrow in scope, others may have fairly general application. For example, the 1984 Act requires that

⁶ "Tax Reform For Fairness, Simplicity, And Economic Growth," Department of the Treasury (November 1984).

appreciation in property distributed, but not taxed to the distributing corporation, be included in earnings and profits. In addition, gains on installment sales generally must be included in full in the year of sale. Moreover, charges to earnings and profits for most stock redemptions will be limited to the ratable share of earnings represented by the redeemed stock.

These particular computational changes are not, however, necessarily the most significant aspect of the 1984 Act changes to Section 312 of the Code. Rather, what appears to be most significant is that these changes may ultimately prove to be but the initial step toward focusing the earnings and profits account, not on taxable income and tax accounting concepts, but on economic income and financial accounting concepts. This shift in tax policy, like the partial burial of *General Utilities*, is significant and reflects yet another area of growing dissatisfaction with what 10 years ago might have been regarded as the fundamental premises of Subchapter C.

One cannot leave the "earnings and profits" changes without reference to the fact that—as noted by many observers in the past several months—the 1984 Act changes begin to sketch the blueprint for an alternative minimum tax on corporate economic income. Such a tax has attracted attention in the last several years as a potential deficit reduction technique and as a way to ameliorate what some believe is an unacceptable disparity in effective corporate tax rates, a disparity which has become more pronounced in the wake of the enactment of the accelerated cost recovery system in 1981.

D. *Net Operating Losses*

In Section 62 of the 1984 Act, Congress again postponed the effective date of the provisions of the Tax Reform Act of 1976 affecting the survival of net operating loss carryovers in corporate acquisitions. One is thus left with pre-1976 law until the end of 1985. Thus, the tax planning focus will continue to be on the mechanical stock ownership and business continuity tests of Section 382 of the Code, the state of mind analysis required by "the principal purpose" test of Section 269 of the Code and the often unanswerable question of whether and to what extent the Supreme Court's 1957 decision in the *Libson Shops*⁷ case has relevance under the 1954 Code.

The policy limbo affecting this narrow but important area of Subchapter C seems likely to come to an end within the next several years. How it will be resolved is, of course, uncertain but it is reasonable to assume that the complex 1976 Act changes have even less vitality than does *General Utilities* and that Congressional hostility toward tax motivated acquisitions will lead to strict, rather than relaxed, rules in this area.

This too is an area that was addressed by the Senate Finance Committee staff in its 1983 study. The staff remedy—to disallow acquiring corporations any greater benefits after the acquisition than would have been available before the acquisition—reflects the hostility to tax-motivated acquisitions

⁷*Libson Shops v. Koehler*, 353 U.S. 382 (1957)

embodied in the TEFRA changes to Subchapter C in 1982. If implemented, however, the staff recommendation will likely involve complexities rivaling those for which the 1976 changes have been so criticized.

E. *Other Subchapter C. Changes*

The other Subchapter C changes included in the 1984 Act generally do not reflect fundamental tax policy shifts so much as they embody the “tinkering” approach that is both one of the hallmarks of the 1984 Act as a whole and a major cause of its length and complexity. Several of these other changes merit special attention.

1. *“C” Reorganizations.* Under prior law, there was no requirement that the acquired corporation actually liquidate in a stock for assets acquisition qualifying as a reorganization under Section 368(a)(1)(C). Section 63 of the 1984 Act adds a new Section 368(a)(2)(G) to the Code to require that the acquired corporation in a “C” reorganization be completely liquidated pursuant to the plan of reorganization. The provision was aimed at transactions where, for example, the acquired corporation transfers substantially all—but not all—its assets in exchange for voting stock of the acquiring corporation, distributes the acquiring corporation’s stock to its shareholders, but keeps its other assets so that its shareholders do not receive so-called “boot” taxable as a dividend.

This mandatory liquidation rule may be waived by regulations in appropriate cases. The legislative history of the 1984 Act indicates that such waivers should be granted only in cases of “substantial hardship” and then only if the acquired corporation and its shareholders are treated as if the retained assets are distributed to the shareholders and contributed to the capital of a new corporation. Whether such regulations will be issued in the near future is obviously uncertain given the current regulations backlog, and the same observations might reasonably be made with respect to the 1984 Act’s direction to issue regulations governing the allocation of earnings and profits in “C” and “D” reorganizations.

2. *“D” Reorganizations.* The 1984 Act also modifies the definition of “control” applicable to non-divisive “D” reorganizations; that is, cases where, for example, one corporation transfers substantially all of its assets to another corporation it or its shareholders control.

Under prior law, the test of control was the general 80 percent test of Section 368(c) of the Code. Under Section 64 of the 1984 Act, in determining whether a non-divisive transaction qualifies a “D” reorganization, “control” is defined as the ownership, directly or indirectly, of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock.

The reduction of the control percentage to 50 percent, the addition of the value concept and the introduction of attribution rules were collectively designed principally to give the Internal Revenue Service (the “Service”) another tool with which to combat so-called “liquidation-reincorporation”

transactions. Such transactions can take a variety of forms—for example, the liquidation of a corporation followed by the immediate transfer of its operating assets to a new corporation owned by the same shareholders—but they all have as their common denominator the extraction of corporate earnings at capital gains rates. Over the years, the Service has employed a variety of theories to challenge such transactions. It has argued that there was no “liquidation” where the operating assets remained in corporate solution and it has often characterized the transaction as a reorganization involving the distribution of “boot” taxable as a dividend. How effective the new tool granted in the 1984 Act will be remains uncertain. However, the legislative history of the 1984 Act makes it clear that this new tool is additive; it does not replace any of those now available to the Service.

3. *Section 338.* The enactment of Section 338 of the Code in 1982 profoundly changed the ground rules for taxable acquisitions. Under Section 338, if a qualifying purchase of a target corporation’s stock is made, an election can be made to obtain a stepped-up basis in the assets of the target corporation. If the election is made, “Old Target” is treated as having sold all its assets in a deemed sale to which Section 337 of the Code applies and, as “New Target,” as having purchased those assets. By reason of the deemed sale, Old Target incurs those tax liabilities, such as depreciation recapture, which override Section 337 and its tax attributes in effect expire. By reason of the deemed purchase, New Target now holds its assets with the requisite stepped-up basis. If a Section 338 election is made, the acquired corporation need not be liquidated, but without a Section 338 election, liquidation results in a carryover basis.

As was to be expected given the pace of the legislative process that produced TEFRA in 1982—a pace that was maintained in 1984—numerous technical corrections were required, and they are embodied in the 1984 Act. One of these new provisions is of particular interest. It involves the situation where a profitable corporation acquires the stock of a corporation with net operating loss carryforwards, declines to make a Section 338 election, and then liquidates Target under Section 332 of the Code, with Target’s tax attributes, including its loss carryovers, carrying over under Section 381 of the Code.

Under the 1984 Act, such treatment is to be denied under amendments to Section 269 of the Code where the acquired corporation is liquidated under Section 332 pursuant to a plan adopted within two years after the acquisition and tax avoidance is the principal purpose of the acquisition. The Conference Report states that this rule is not intended to cause the disallowance of loss carryover deductions and other tax benefits of an acquiring corporation which makes a qualified purchase of the stock of another corporation, declines to elect Section 338 and liquidates the target corporation, where the transaction results in no change in ownership of purchasing corporation’s stock. Thus, the 1984 Act continues what might be described as a tradition that a loss corporation may “rehabilitate” itself through acquisitions of profitable

businesses without jeopardizing its favorable tax attributes, while more strict rules are imposed where profitable corporations acquire loss corporations.

While the change was no doubt necessary given the purposes of Section 338, reliance on the subjective "principal purpose" test illustrates the need for some more objective criteria for determining the extent to which loss carryovers should survive in corporate acquisitions. As noted earlier, however, while the prospect for more objective rules may be good, those rules are likely to be quite restrictive.

4. *Collapsible Corporations.* As noted earlier, in its 1983 study, the staff of the Senate Finance Committee concluded that the collapsible corporation rules of Section 341 of the Code could be repealed if the *General Utilities* doctrine was abolished in its entirety. Since *General Utilities* still exists in the liquidating distribution context, Section 341 remains in the Code and, indeed, was toughened somewhat by Section 65 of the 1984 Act.

The principal change in the collapsible corporation rules is the statutory override of the 1961 decision in the *Kelly* case, a decision the Internal Revenue Service had agreed to follow.⁸ *Kelly* in effect held that the "substantial realization" test of Section 341(a) was met in those situations where the corporation has realized at least one-third of the potential taxable income from the so-called "collapsible assets." Under the 1984 Act, the corporation must realize at least two-thirds of the potential taxable income. As a result, the collapsible corporation rules may have new vitality, at least until, or perhaps unless, the *General Utilities* doctrine is completely abolished.

5. *Section 367.* A final set of changes which merit brief comment are those relating to transfers of property outside the United States. For many years, the basic statutory mechanism for such cases was to require the taxpayer to establish in advance and to the satisfaction of the Service that the transfer was not undertaken for tax avoidance purposes. In 1968, the Service issued guidelines for such rulings.⁹ These guidelines acknowledged that Section 367 focused on tax avoidance purposes, but they also took the position that the so-called "outward bound" transfer of some types of assets, such as inventory, had the effect of tax avoidance and thus required payment of a so-called "toll charge" when transferred abroad. In the Tax Reform Act of 1976, Congress created a Tax Court declaratory judgment procedure for taxpayers who were denied favorable rulings under Section 367. The Service however lost several of its initial test cases and the entire area of so-called "outbound transfers" became unsatisfactory both for taxpayers and for the Service.

Section 131 of the 1984 Act seeks to remedy this situation in several important respects. First, the old subjective "tax avoidance" test of Section 367(a) has been repealed in favor of a series of objective tests which conform in most important respects to the 1968 Service guidelines. In general, the new rule focuses upon granting tax-free treatment where the transferred assets are to be used in the active conduct of a foreign trade or business. So-called

⁸*Commissioner v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

⁹*Rev. Proc. 68-23*, 1968-1 C.B. 821.

“tainted assets,” such as inventory, are nevertheless in general subject to a statutory toll charge. Second, a notice requirement has been substituted for the advance rulings-declaratory judgment procedures of prior law. Finally, special rules are provided for the transfer of intangible assets and for the incorporation of foreign branches with losses.

II.

Selected Nonlegislative Developments

Obviously, the 1984 Act changes to Subchapter C are more complex than the brief summary attempted here. This complexity is heightened by the fact that many of the provisions require the issuance of regulations, a process that may take years. Nevertheless, while the 1984 Act obviously is the headline event, the annual flow of cases, rulings and the like yielded several developments that warrant identification and comment.

A. Partnership Incorporations.

Although having implications beyond the scope of Subchapter C, one of the more significant nonlegislative developments of 1984 involves the revision by the Service of its tax analysis of the various methods of incorporating a partnership. In *Rev. Rul. 70-239*,¹⁰ the Service used substance over form analysis to treat each of three common methods of incorporating a partnership as involving a transfer by the partnership of its assets to the new corporation under Section 351 in exchange for stock, followed by a distribution of the stock to the individual partners.

In actuality, however, the premise of *Rev. Rul. 70-239*—that the Federal income tax consequences are the same whether the transfer of assets is by the partnership, or whether the partnership terminates and the partners transfer the assets, or whether the partners transfer their partnership interests to the corporation followed by a termination of the partnership—proved to be not entirely correct. For example, in one private letter ruling, the Service relied on *Rev. Rul. 70-239* to deny “Section 1244 Stock” treatment on a partnership incorporation.

In *Rev. Rul. 84-111*,¹¹ the Service conceded that the methods of incorporation could in fact have an effect on the basis and holding periods of the assets received by the corporation and on the basis and holding periods of the stock received by the partners. The Service also noted that the method selected could have important collateral tax consequences in cases involving collapsible corporations, personal holding companies, section 1244 stock and S corporations. To remedy what obviously had become a trap for the unwary, *Rev. Rul. 84-111* honors the form chosen by the parties and prescribes in detail the tax consequences of each method of incorporation.

¹⁰1970-1 C.B. 74.

¹¹1984-30 IRB 6.

B. Section 351 and Taxable Acquisitions

For several years, there has been some controversy concerning the application of Section 351 to exchanges which occur in the context of larger acquisitive transactions that do not qualify as tax-free reorganizations for lack of the requisite continuity of proprietary interest. For example, consider the case of a target corporation most of whose shareholders are prepared to sell their stock to a corporation which seeks to acquire the stock of Target and operate it as a subsidiary. To accommodate the wishes of the minority shareholders of Target who are not willing to recognize the gain on a stock sale, the acquiring corporation establishes a holding company subsidiary. The minority shareholders of Target transfer their stock of Target to the holding company subsidiary for preferred stock and the acquiring corporation acquires the common stock of holding company for cash, which the holding company uses to acquire the remaining stock of Target.

In *Rev. Rul. 80-284*,¹² the Service held that Section 351 did not apply to the transfer to the holding company subsidiary of the stock of Target by the minority shareholders of Target. The rationale for the ruling was that, first, the transaction as a whole fit a pattern common to acquisitive reorganizations, and second, a well-established continuity of interest test applies to such reorganizations and where, as in the facts just described, that test is not met, all parties should recognize gain. In *Rev. Rul. 80-285*,¹³ the Service reached the same result where assets, rather than stock, of Target were acquired under similar circumstances.

These two rulings were subjected to substantial criticism on technical grounds, in part because continuity of interest is not required in recapitalizations qualifying as reorganizations under Section 368(a)(1)(E), and also because of the seeming inconsistency of the 1980 rulings with *Rev. Rul. 76-123*,¹⁴ which some had read to suggest that a Section 351 exchange could occur in the context of a larger transaction.

In *Rev. Rul. 84-71*, the Service revoked the two 1980 rulings and held that, if the technical requirements of Section 351 were otherwise satisfied, it would apply to an exchange that was part of a larger transaction that failed the continuity of interest test. It should be pointed out, however, that *Rev. Rul. 84-71* may not be the last word on the subject. Indeed, the use of subsidiary holding companies in this fashion was highlighted by the Senate Finance Committee staff in its 1983 study as an illustration of the problems of the current continuity of interest test.

In the interim, however, it appears that Section 351 offers what might be characterized as an alternative to the more strict reorganization rules where one or more shareholders of the target corporation hold appreciated stock and are unwilling to participate in a taxable sale of their stock.

¹²1980-2 C.B. 117.

¹³1980-2 C.B. 119.

¹⁴1976-1 C.B. 123.

In this connection, reference should be made to two recent decisions in which courts accepted the position that continuity of proprietary interest is not required for a recapitalization to qualify as a reorganization. Those cases, *Microdot*¹⁵ and *Golden Nugget*,¹⁶ each involved the issuance of debentures in taxable exchanges for common stock followed by an attempt by the issuing corporation to claim deductions for original issue discount with respect to the debentures. In both cases, the Service argued successfully that a recapitalization had in fact occurred with the result that no deduction was allowable for original issue discount.

The original issue discount rules were amended by Congress in 1982 and substantially revised in 1984. As a result, the principal value of these cases lies in the holding with respect to the scope of the term "recapitalization" and as an illustration that, like many of the liquidation-reincorporation cases, the litigating positions of the Service and of taxpayers may well be different from that which normally occurs.

C. Stock Redemptions

Two recent cases illustrate different but potentially important facets of the question when redemptions will qualify for capital gain treatment.

In the first case, *Patterson Trust v. United States*,¹⁷ the question was whether the redemption of stock held by a trust was essentially equivalent to a dividend. In applying the standard "meaningful reduction" test set forth by the Supreme Court in 1970 in the *Davis* case,¹⁸ the court was faced with the Service's argument that, despite the literal language of Section 318(a)(4), a person should be treated as owning stock he has an option to purchase only if he is the taxpayer—here the trust—or if his shares would otherwise be attributed to the taxpayer. The issue was of course significant to computation of the amount of the corporation's stock which was outstanding. Based upon what it described as a plain reading of the statute, the court rejected the Service's argument, thus aligning itself with the Tenth Circuit's decision in *Sorem*¹⁹ and conflicting with the apparent position of the First Circuit in *Friend*.²⁰ While the Supreme Court is not likely to take such a case despite the conflict among the Circuits, taxpayers should be wary of situations which could not otherwise satisfy the "meaningful reduction" test.

The second case, *Seda v. Commissioner*,²¹ raises a warning signal for situations in which a redemption qualifies as a complete termination of interest under Section 302(b)(3) only if the requirements for waiver of the family attribution rules are met. Under Section 302(c)(2)(A), waiver of the family attribution rules requires that the shareholder whose stock is redeemed not

¹⁵728 F.2d 593 (2d Cir. 1984).

¹⁶83 T.C. , No. 4 (1984).

¹⁷729 F.2d 1089 (6th Cir. 1984).

¹⁸*United States v. Davis*, 397 U.S. 301 (1970).

¹⁹*Sorem v. Commissioner*, 334 F.2d 275 (10th Cir. 1964).

²⁰*Friend v. United States*, 345 F.2d 761 (1st Cir. 1965).

²¹82 T.C. , No. 36 (1984).

retain a non-creditor interest in the distributing corporation, including an interest as an "officer, director, or employee." Although all of the Tax Court Judges agreed that Mr. Seda had retained a prohibited interest, the Judges split sharply over a statement in the majority opinion that the retention of all employment relationships might not be prohibited. The concurring Judges took the opposite view; namely, that Congress did in fact intend to prohibit all employment relationships, and they distinguished the *Lewis* case, cited by the majority, as simply establishing that a nominal officer or director who performs no duties, receives no compensation and exercises no influence has not retained a prohibited interest.

One suspects that the Tax Court will in the future find a case in which to confirm that it will not generally inquire into the level of employment in cases which go beyond the *Lewis* situation. In the interim, one should proceed with a great deal of caution in cases where waiver of the family attribution rules is essential.

D. *Other Developments*

Most of the other developments occurring during 1984 involve highly specialized situations, but several do illustrate problem areas that might have been avoided by careful planning.

For example, while substance over form is a frequently cited rubric in Subchapter C analysis, form sometimes counts a great deal. The holding of *Rev. Rul. 84-44*²² illustrates the point. In that ruling, as part of a single transaction, assets were transferred to a parent corporation and its subsidiary, with both transferors receiving parent corporation stock. Unfortunately for the taxpayer that transferred assets to the parent corporation, Section 351 did not apply to the transfer since the requisite control was not met even though it could have been met jointly if the assets transferred to the subsidiary were counted.

Consider also the decisions of the Tax Court in *Goldstein*²³ and *Pulliam*.²⁴ Collectively, they apply no new legal principles in determining whether the redemption of one shareholder's stock is a constructive dividend to the continuing shareholders. But they do illustrate the need for an independent corporate purpose even where the "paperwork" appears to make the corporation primarily liable and the fact that even "sloppy paperwork" suggesting that the continuing shareholder was primarily liable to acquire the stock may be overcome.

III.

Concluding Observations

Looking back, the mosaic that is Subchapter C was altered in 1984 by legislation as well as by the usual flow of cases and rulings. In technical

²²1984-15 IRB 5.

²³T.C. Memo. 1984-62.

²⁴T.C. Memo. 1984-470.

terms, however, the principal nonlegislative developments appear to have been overshadowed by the new rules requiring recognition of corporate level gain on non-liquidating distributions of appreciated property. In the present circumstances, however, the traditional "snapshot" of the preceding year is a bit deceptive. Indeed, one can make the case that, even in an area generally regarded as staid as Subchapter C, the significant current development is the groundwork that has been laid for a comprehensive revision of Subchapter C and possibly for more broad-based tax reform that could have a substantial, even if indirect, impact on Subchapter C. Despite the magnitude and complexity of the 1984 Act, the confluence of increased interest in fundamental tax reform and concern over the possible need for future revenues to reduce projected Federal deficits may in 1985 or 1986 produce tax legislation that will make 1984 seem in retrospect a somewhat modest year.

Obviously, proposals for broad-based, low rate individual and corporate income taxes do and will continue to dominate the headlines. Some of these proposals would eliminate the preference for capital gains. If this were to occur, many of the Subchapter C provisions aimed at attempts to bailout corporate earnings at capital gains rates would become unnecessary. Other proposals, such as the partial deduction for dividends paid discussed earlier, raise interesting relationship questions with one or more provisions of Subchapter C.

In addition, as noted earlier, it should be recognized that there remains a substantial unfinished agenda with respect to the revision of Subchapter C. That agenda is set forth in the 1983 study by the Senate Finance Committee Staff and it may well form the basis for future legislation in 1985 or 1986. For example, that study calls for a significant revision to the rules governing mergers, acquisitions and other reorganizations. The current rules would, in general outline, be replaced by an election to choose between recognition and nonrecognition at the corporate level, but cost basis rather than carryover basis would be available to the transferee only if the corporate transferor recognized gain. In addition, as noted earlier, the last vestiges of the *General Utilities* doctrine would be repealed so that liquidation would generally be a taxable event for the liquidating corporation.

While these proposals are admittedly staff recommendations, the tax bills of 1982 and 1984 reflect a substantial and continuing concern on the part of Congress with respect to the extent to which the Federal income tax stimulates mergers, acquisitions and other corporate transactions that might not otherwise be undertaken. Thus, within the context of Subchapter C, as well as in the broader context of the income tax as a whole, the ground work for change—perhaps fundamental change—may be the most significant current development.

In the interim, however, we are forced to content ourselves with the near impossible task of understanding the recent additions to the Internal Revenue Code. The highlights selected here for brief comment illustrate the magnitude of the task and the difficulty of achieving certainty of result except in the most mainstream of cases.