THIRTY-SECOND
WILLIAM AND MARY
TAX CONFERENCE

CORPORATE TAX CHANGES
IN THE 1986 TAX REFORM ACT

by

Richard E. May
Hunton & Williams

December 5-6, 1986
Williamsburg

The speaker wishes to acknowledge that portions of this outline were graciously made available by Messrs. Mark J. Silverman, William C. Bowers, and Robert H. Wellen, all colleagues in the Section of Taxation of the American Bar Association.
I. Selected changes affecting taxation of corporations.*

A. Corporate rate changes. The 1986 Act makes changes to the corporate rates for both ordinary income and capital gains. Each is described below.

1. Rates for ordinary income. (1986 Act, § 601). The 1986 Act sets the maximum corporate rate on ordinary income at 34 percent for taxable income in excess of $75,000. Lower rates apply to taxable income below that amount as follows:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 or less</td>
<td>15%</td>
</tr>
<tr>
<td>$50,001 - $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>$75,001 or more</td>
<td>34%</td>
</tr>
</tbody>
</table>

There is a phase-out of the benefit of the two lower rates of tax. The phase-out occurs through the imposition of an additional five-percent tax between $100,000 and $335,000 of taxable income.

a. Effective date. The new rates are effective for taxable years beginning on or after July 1, 1987. Income in taxable years that include July 1, 1987 (other than as the first date of such year), is subject to a blended rate under § 15. Thus, for a calendar-year taxpayer a maximum blended rate of 40 percent will

*All references to Code sections are to sections of the Internal Revenue Code of 1986. Sections of the Internal Revenue Code of 1954 are referred to as "old Code sections." The Tax Reform Act of 1986 is referred to as "1986 Act, § ___."
apply for calendar year 1987. For a July 1 - June 30 fiscal year taxpayer, the maximum rate on its 1986-87 taxable income will be 46 percent, and on its 1987-88 taxable income will be 34 percent.

2. Rates for capital gains. (1986 Act, § 311). The 1986 Act effectively repeals the alternative tax of old Code § 1201. Thus, net capital gain will be taxed at regular corporate rates (generally a maximum of 34 percent). The conference report specifically states that the current statutory structure for capital gains is retained (notwithstanding the conformity of rates for ordinary income and capital gains) to facilitate reinstatement of a capital gains rate differential in the event there is a future tax rate increase.

a. Effective date. The new higher rate on capital gains will be effective for gain "properly taken into account" on or after January 1, 1987. Thus for calendar-year taxpayers, the new rates are effective for 1987. For fiscal-year taxpayers, gain taken into account under the taxpayer's method of accounting before 1987 will be entitled to the lower rates of current law; gain taken into account in 1987 will be subjected to the new, higher rates.

b. Comment. Removal of the capital gains/ordinary income rate differential is potentially one of the most far-reaching corporate changes in the 1986 Act. Coupled with repeal of the General Utilities doctrine, discussed infra, it may be possible to repeal the collapsible corporation
provisions, and certainly the operation of the §§ 302, 304 redemption provisions, the accumulated earnings provisions, the personal holding company provisions, and the recapture provisions will also be affected. It will still be necessary, however, to keep track of basis and holding periods for other purposes.

B. Dividends received deduction. (1986 Act, § 611). The 85-percent dividends received deduction for dividends received from so-called "non-controlled" corporations is reduced to 80 percent. Conforming changes are made to old Code §§ 243, 244, 246, and 246A.

1. Rationale for change. The reduction of the dividends received deduction from 85 percent to 80 percent was justified as a conforming change to reflect the drop in the maximum corporate rates. The 85 percent deduction at a 46 percent tax rate yielded an effective tax rate on corporate dividends of 6.9 percent (46% x 15% = 6.9%). The new 80 percent deduction at a 34 percent tax rate will yield a comparable tax rate on corporate dividends (34% x 20% = 6.8%).

2. Effective date. The change in the deduction percentage for dividends received by corporations applies to dividends received or accrued after December 31, 1986.

C. Stock redemption payments. ("Greenmail payments"). (1986 Act, § 613) A new subsection 162(1) is added to deny expressly a current deduction for "any amount paid or incurred by a corporation in connection with the redemption of its stock." Although the statute is silent as to what constitutes amounts paid or incurred "in connection with" a redemption, the legislative history lists
the following items: "amounts paid to repurchase the stock, premiums paid for the stock, legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with the repurchase; and any other expenditure that is necessary or incident to the repurchase. . . ." (Senate Report p. 223). Thus, the provision is intended to apply broadly.

1. **Standstill Agreements.** The provision is also intended to apply to amounts paid pursuant to agreements where the payee agrees not to purchase, finance a purchase, or in any other way assist in an acquisition of the redeeming corporation's stock -- so-called "standstill" agreements. Query: Does the provision apply if amounts for a standstill are paid but no stock is redeemed?

2. **Amounts excluded from rule.** The statute expressly excludes interest deductible under § 163 and deductible dividends (as defined in § 561) for purposes of applying the accumulated earnings, personal holding company, and foreign personal holding company taxes, and for the regular income tax for regulated investment companies ("RIC's") and real estate investment trusts ("REIT's"). It also does not apply to otherwise deductible expenses incurred by an open-end mutual fund for redemptions on its stock on demand of a shareholder.

3. **Reason for the rule.** The legislative history makes clear a Congressional intent to foreclose arguments by some taxpayers that payments for standstill agreements and premiums paid to redeem stock from corporate raiders were deductible. The legislative history makes reasonably clear the Congressional view that such amounts are not deductible, casting doubt on prior authority cited by
taxpayers to support deductibility. The decisions in Woodward v. Commissioner, 397 U.S. 572 (1970), and United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), are cited for their broad vitality in requiring capitalization of redemptions and similar capital corporate transactions. Note, however, that the committee reports state that no inference is intended under current law regarding (1) deductibility of such expenditures, or (2) the character of such payments in the hands of the payee.

4. Effective date. This provision is effective for amounts paid or incurred after February 28, 1986.

D. Extraordinary dividends. (1986 Act, § 614). Section 1059 added by the 1984 Tax Act, which requires a basis reduction for certain extraordinary dividends if the underlying stock is sold, is modified and expanded in the 1986 Act.

1. Background. Old Code § 1059 was enacted in 1984 to prevent a perceived abuse created by the dividends received deduction. Prior to the 1984 Act, it was possible for a corporation to buy the stock of another corporation which was about to declare an extraordinary dividend. The purchasing corporation would be entitled to exclude 85 percent of the dividend under § 243 (now 80 percent under the 1986 Act) and, because the value of the stock presumably would drop to reflect the dividend, the corporation would be entitled to a loss when it sold the stock shortly thereafter. Congress thought this "double tax benefit" was too generous, and required a basis adjustment (thus reducing the loss on sale) by the "nontaxed portion" of the dividend if the stock had not been held for more than one year. An extraordinary dividend was generally defined as one
which exceeds 10 percent (5 percent in the case of preferred stock) of the shareholder's basis in the stock.

2. **Reason for the change.** The committee reports express a concern that old Code § 1059 was not operating adequately and that holding the stock for only one year did not necessarily subject the taxpayer to sufficient market risk. The Senate's version of this provision would have required a basis reduction for all extraordinary dividends, irrespective of the length of holding period. It also would have permitted the taxpayer, upon sufficient showing, to substitute fair market value (in lieu of cost basis) as of the day prior to the ex-dividend date in measuring whether a dividend is extraordinary.

3. **Conference agreement.** The conference agreement made changes and additions to the Senate version as follows:

   a. **Holding period.** Section 1059(a) requires that basis must be reduced by extraordinary dividends if the stock has not been held for more than 2 years before the dividend announcement date.

   b. **Dividend announcement date.** This date is defined in §1059(d)(6) as the earliest date on which the paying corporation declares, announces, or agrees to the payment of the dividend. The conference report clarifies that the existence of both formal and informal agreements to pay the extraordinary dividend are to be determined on all the facts and circumstances. A general agreement that dividends
will be paid as funds are available ordinarily will not be considered an agreement fixing a dividend payment date.

c. Special rule for new corporations. A dividend that otherwise would be extraordinary under the two-year rule will not trigger a basis reduction if the distributee corporation has held the stock for the entire period of the paying corporation's (or its predecessor's) existence. § 1059(d)(7).

d. Option to use fair market value. The conference committee adopted the Senate proposal to permit use of fair market value (in lieu of cost) on the day before the dividend announcement date in measuring whether a dividend is extraordinary. § 1059(c).

e. Partial liquidations and non-pro rata distributions. Section 1059(e)(1) provides that any redemption of stock which a partial liquidation (defined in § 302(3)) of the redeeming corporation and any non-pro rata distribution treated as a dividend under § 301 will always be treated as an extraordinary dividend (without regard to holding period).

f. "Qualifying dividends". Certain qualifying dividends on preferred stock -- so-called "qualifying preferred dividends" are excepted from these rules under § 1059(e)(2)-(3).

4. Effective dates. The new rules generally apply to dividends declared after July 18, 1986. The special rule
treated redemptions in partial liquidation and non-pro rata dividends as extraordinary dividends is effective for such dividends declared after date of enactment of the 1986 Act.

E. Allocation of purchase price in asset acquisitions. (1986 Act, § 641) New Code § 1060 generally requires that the manner of allocating basis to assets under a section 338 election shall also be required in allocating basis in straight, taxable asset acquisitions involving the transfer of a trade or business.

1. Background. Under § 338(b)(5) Treasury was authorized to issue regulations prescribing methods of allocating purchase price for stock acquisitions where a section 338 election was timely made. Treasury finally issued its basis allocation regulations in proposed and temporary form on January 29, 1986. Prop. and Temp. Treas. Reg. § 1.338(b)-2T. To the surprise and dismay of some, those regulations mandated use of the so-called "residual method" and rejected use of the so-called "second-tier method." The effect of mandating the residual method was to allocate the "premium" element of a purchase price (i.e. the amount paid in excess of the fair market value of non-goodwill assets) to goodwill and going concern value. Treasury was reported to have been concerned that otherwise assets could have amounts allocated to them in excess of fair market value with consequent increase in depreciation or amortization deduction. No comparable regulatory authority was granted to Treasury to prescribe allocation methods in asset acquisitions outside § 338.

2. Conformity for all asset acquisitions. Section 1060 requires, in effect, that the residual method of
allocating purchase price must be used in so-called "applicable asset acquisitions." Thus, Treasury is granted the regulatory authority that it previously lacked to conform the allocation of purchase price in a section 338 situation with other asset acquisitions involving the transfer of a trade or business.

a. "Applicable asset acquisition." An applicable asset acquisition is defined to include any transfer, whether directly or indirectly, of assets which constitute a trade or business and whose basis is determined wholly by the consideration paid.

b. Trade or business. The legislative history provides some guidance on what constitutes a trade or business for this purpose. It involves any transfer of a group of assets "if their character is such that goodwill or going concern value could under any circumstances attach to such assets." Senate Report at p. 255. Any group of assets which constitute an active trade or business under § 355 will qualify, and a business that may not qualify as "active" will nevertheless be deemed a trade or business for this purpose. Id.

c. Information reporting. Section 1060(b) grants broad regulatory authority to Treasury to issue regulations requiring the transferor and transferee in an applicable asset acquisition to provide information on the allocation of purchase price. This authority was granted to Treasury in order to diminish the "whip saw"
potential of the parties making inconsistent allocations.

d. Inference under prior law. The Senate Report (p. 254) states that no inference is intended on the proper allocation method for such asset acquisitions under prior law.

3. Effective date. This provision applies to any acquisition of assets after May 6, 1986, unless the acquisition is pursuant to a binding contract which was in effect on May 6, 1986.

F. Treatment of related party sales. (1986 Act § 642). A number of Code provisions provide different, often harsher, treatment of sales of property if those sales occur between related parties. For example, under old Code § 453, installment sale treatment was not available for sales between related parties. Similarly, gain on sales between related parties could be characterized under old Code § 1239 from capital gain to ordinary income, and loss could be denied under old § 267 upon sales between related parties.

1. Background -- 80-percent tests. The old Code sections described above all required that an entity to the sale be 80-percent controlled before the provisions be applied. See old Code §§ 453, 267 and 1239.

2. New 50-percent tests. In each instance, the 1986 Act substitutes a new 50-percent test in lieu of the 80-percent tests imposed by the old Code. See §§ 453(f), 1239(b), (c)(1). The 1986 Act coins the new term "controlled entity" to describe an entity which possesses the requisite relationship.
3. **Attribution.** In determining whether there is the requisite 50-percent relationship, the attribution and relationship rules of prior law continue to apply in determining whether the relationship exists.

4. **Treatment of certain contingent installment sales.** The 1986 Act specifies the treatment of contingent amounts, for purposes of qualifying for installment sales treatment where there is a sale of depreciable property between related parties defined under §§ 1239(b) and 453(g). As a general rule, non-contingent payments do not qualify for installment treatments. Payments which are contingent as to amount, and for which a fair market value cannot be ascertained, may be recovered ratably, but no amount of the contingent payment may be allocated to the underlying property until the seller includes the amount in income. Id.

5. **Effective dates.** These changes generally apply to sales after date of enactment, with an exception provided for sales made after that date pursuant to a binding contract in effect on August 14, 1986.

G. **Computer software royalties under personal holding company provisions.** Section 645 of the 1986 Act exempts certain royalties relating to computer software from the definition of personal holding income (§ 453(a)(1)(c), (d)) and from foreign personal holding income (§ 553(a)). If the rules of new § 453(d) are satisfied, the software royalties will not be included when determining whether the company meets the 60-percent test for purposes of imposing the special 50-percent tax on undistributed personal holding company income.
1. Definition of "active business computer software royalties." To qualify for the exemption several tests must be satisfied.

   a. Licensing. The royalties must be received from the licensing of computer software. § 543(d)(1).

   b. Active business. The corporation receiving the royalties must be engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software. § 543(d)(2).

   c. 50-Percent income test. The royalties must constitute at least 50-percent of the corporation's ordinary gross income for the taxable year. § 543(d)(3).

   d. 25-Percent deduction test. The deductions under §§ 162, 174, and 195 allocable to the software trade or business must equal or exceed 25 percent of the ordinary gross income of the corporation for the taxable year, or, the average of such deductions during the most recent 5 years must meet the 25-percent test. (If a corporation has not been in existence for 5 years, the period of its existence is the appropriate measure). § 453(d)(4).

   e. 10-Percent dividends test. The sum of the dividends paid (§ 562), the dividends deemed paid on the last day of the taxable year (§ 563), and the consent dividends (§ 565), must equal or exceed 10 percent of the corporation's ordinary gross income. § 543(d)(5).
For this purpose, personal holding income does not include the software royalties of the 50-percent income test and the 25-percent deduction test. Several other adjustments are also required in applying this 10-percent dividends test.

*   *   *   *   *   *   *   *   *

13
THE REPEAL OF THE GENERAL UTILITIES
DOCTRINE BY THE TAX REFORM ACT OF 1986:
BACKGROUND, ANALYSIS AND PLANNING STRATEGIES

I. INTRODUCTION

A. Proposed Repeal of the General Utilities Doctrine

On August 16, 1986, the House-Senate Conferees to the Tax Reform Act of 1986, H.R. 3838, agreed upon the provisions of a bill which, if passed, would repeal the last vestige of the so called General Utilities doctrine.

1. In its remaining manifestation, the General Utilities doctrine provides that when a corporation distributes appreciated property in complete liquidation, the shareholders receive a basis reflecting the property's fair market value on the date of the distribution, yet the corporation recognizes no gain except for recapture items. It is a rule of corporate level nonrecognition.

2. The result of the rule is that appreciation in the value of the corporation's assets is never taxed and the shareholder receives a step-up in basis upon which a new round of depreciation, depletion and amortization deductions may be taken.

3. With exceptions for liquidations completed before the end of 1986, for plans of liquidation adopted and certain other actions taken before August 1, 1986, and for small, closely held companies, the proposed repeal of the General Utilities rule would be effective generally for liquidating sales and distributions after July 31, 1986 and nonliquidating distributions after December 31, 1986. See part IV.C., infra.

* The author would like to thank Norman B. Richter of Steptoe & Johnson for his assistance in preparing this outline.
B. The General Utilities Doctrine Represents An Anomaly

The General Utilities doctrine may be understood as an anomalous exception to two fundamental principles of our tax system.

1. Basis adjustment principle

The General Utilities doctrine is an exception to the general principle of the Internal Revenue Code (the "Code") that the transferee of appreciated property receives a new basis in the property reflecting his cost only if the transferor recognizes gain.

a. Where the Code does permit gain to go unrecognized upon the transfer of appreciated property, it ordinarily exacts a "price" by denying the transferee a cost basis; the transferee in such instances ordinarily must take a carryover basis in the property it receives. See, e.g., § 358. In contrast, the General Utilities rule does not exact such a price. (One other notable exception is the rule that property transferred at death receives a new basis equal to its fair market value at death without recognition of gain by the decedent or his estate, § 1014).

b. Because of the General Utilities rule, in the case of a complete liquidation, the corporation does not recognize gain upon the distribution of appreciated property, but the shareholder nevertheless obtains a cost basis in the property. It frequently is observed that it is this basis step-up (with its opportunity for fresh depreciation, depletion and amortization deductions), and not the failure to tax gain at the corporate level, that represents the primary revenue loss to the government from the General Utilities rule.

2. Two-tier taxation

Moreover, the General Utilities doctrine is an exception to a second general principle of the Code, the principle that corporations and shareholders are separate taxpayers. Subchapter C contemplates that, in general, tax will be imposed once upon income when it is realized by
the corporation and again when that income is
distributed to the shareholders.

a. A shareholder, upon receiving a distribu-
tion in liquidation, must recognize gain
measured by the difference between the fair
market value of the shareholder's stock and
his basis in such stock. § 331. The
amount of this gain often bears no rela-
tionship whatsoever to the amount of the
corporate level appreciation in distributed
assets (appreciation which is not taxed at
the corporate level by virtue of the
General Utilities rule). Thus, the
appreciation of corporate assets not only
escapes taxation at the corporate level but
may escape taxation altogether.

b. The exception to the two-tier system of
taxation represented by the General
Utilities doctrine has been called "the
central distortion of our corporate tax
structure." B. Wolfman, Corporate Distri-
butions of Appreciated Property: The Case
for Repeal of the General Utilities
Doctrine, 22 San Diego L. Rev. 81, 82
(1985). The distortion "produces strains
on the system as taxpayers attempt to
arrange their affairs to take advantage of
the single-tax part of the system." N.Y.
Relating to General Utilities Repeal (April
1986).

c. Other commentators have defended the
General Utilities doctrine as a much needed
mechanism bringing about at least some
integration of corporate and individual tax
rates. See J. Gould, General Utilities
Repeal: Tax Reform Should Pass It By, 31
Tax Notes 147 (1986). The double taxation
of corporate earnings is regarded by some
as a factor hampering the competitiveness of
U.S. corporations in the world economy. See
J. Nolan, Taxing Corporate Distributions of
Appreciated Property: Repeal of the General
Utilities Doctrine and Relief Measures, 22
II. HISTORY OF THE GENERAL UTILITIES DOCTRINE

A. Genesis of the General Utilities Doctrine

In General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), the U.S. Supreme Court appeared to hold that a corporation which distributed appreciated property as a dividend to its shareholders did not recognize taxable income on the distribution. There is disagreement whether the Court ever reached this issue on substantive grounds.

1. Codification

This principle was codified in the 1954 Code in § 311(a) with respect to nonliquidating distributions, and in § 336 with respect to liquidating distributions. A similar rule was adopted in § 337 for sales of assets made in connection with liquidations.

2. Misnomer

In 1984, Congress reversed the general nonrecognition rule of § 311 to provide that corporations would, in general, recognize gain upon nonliquidating distributions of appreciated property. Because the General Utilities decision involved a nonliquidating distribution, the rule of that case therefore was directly repealed in 1984.

It is the extension of the original General Utilities rule to liquidating distributions that has remained in issue. It is this extension that now carries the General Utilities name although, strictly speaking, the title is a misnomer.

B. Erosion of the General Utilities Doctrine: Statutory and Judicial Limitations on Nonrecognition

1. Statutory Overrides

Since 1954, Congress has repeatedly enacted new rules which limit and override the nonrecognition treatment provided under the General Utilities provisions: §§ 311, 336 and 337.

a. LIPO inventory

When the nonrecognition rule of § 311(a) was enacted in 1954, it was made subject to
an exception for distributions of LIFO inventory items. § 311(b). In 1980, a similar exception was added by § 336(b) for liquidating distributions. See also § 337(f) (similar provision for bulk sales of LIFO inventory items).

b. Installment obligations

In 1954, § 311(a)'s nonrecognition rule also was made subject to an exception for distributions of installment obligations. See § 453B. The rule for liquidating distributions, § 336, provided a similar exception to nonrecognition. § 336(a). See also § 337(b)(1) (defining "property" the sale of which is subject to gain nonrecognition to exclude certain installment obligations).

c. Liabilities in excess of basis

Section 311(a) also was made subject to a gain recognition exception for property distributed subject to a liability in excess of the corporation's basis. § 311(c). However, § 336 does not require a liquidating corporation to recognize gain under these circumstances.

d. Recapture property

In 1962, Congress enacted § 1245 and in 1964, enacted § 1250, provisions which override the nonrecognition rules of § 311, § 336 and § 337. Sections 1245 and 1250 recapture depreciations deductions upon the distribution or sale of depreciable property. See also §§ 47 (investment tax credit recapture), 291, §§ 617(d), 1251, 1252, 1253 and 1254.

e. Nonliquidating distributions in redemption

In 1969, Congress added § 311(d) to the Code which provided, subject to various exceptions, that corporations would recognize gain where appreciated property was used to redeem stock. This represented a significant partial repeal of the General Utilities rule with respect to nonliquidating distributions.
f. Partial liquidations

In 1982, partial liquidations were removed from the coverage of § 336 and subjected instead to the rule of new § 311(d) which limited corporate level nonrecognition treatment to partial liquidation distributions with respect to stock owned by a narrowly defined set of noncorporate shareholders.

g. S corporations

In 1982, Congress added § 1363(d) to the Code which provides that an S corporation will be required to recognize gain upon a nonliquidating distribution of appreciated property. A similar rule was not, however, provided for liquidating distributions.

h. Collapsible corporations

The nonrecognition provisions of §§ 311, 336 and 337 are overridden if the distributing corporation previously consented to recognize gain upon certain of its assets pursuant to § 341(f). Moreover, § 337 is inapplicable to liquidating sales of appreciated inventory or other property held by a collapsible corporation for sale to customers.

i. Nonliquidating distributions generally

In 1984, the general nonrecognition rule of § 311(a) finally was completely reversed with the amendment of § 311(d)(1); under this new rule, subject to a few relatively narrow exceptions, corporations recognize gain upon all nonliquidating distributions of appreciated property. Accordingly, nonrecognition under § 311(a) continues to apply only to gains under the narrow exceptions and to losses. The House report asserted that the switch to a general rule of gain recognition was entirely consistent with a "double-tax system" applicable to corporations and shareholders. H. Rep. No. 98-432, 98th Cong., 2d Sess. 1190 (1984).
j. Partnership and trust interests

In 1984, § 386 was added to the Code as a "look-through" rule to recognize corporate level gain upon the distribution of partnership (and trust) interests, to an extent depending on the amount of the partnership's (or trust's) property which is "recognition property," i.e., property with respect to which gain would be recognized had it been directly distributed by the corporation in a transaction subject to § 311 or § 336. See also § 386(c)(2) (similar rule for sales of partnership or trust interests in § 337 liquidations).

k. Clear reflection of income

Section 446(b) grants the Commissioner the authority to change a taxpayer's method of accounting if that method does not clearly reflect income. Similarly, § 482 grants the Commissioner broad authority to allocate income and deductions among related taxpayers where such allocation is necessary to prevent avoidance of taxation or clearly to reflect income. These two sections have been invoked in connection with cash method taxpayers and certain accrual method taxpayers to prevent the nonrecognition of gain in the year that the business terminates. See Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir.), cert. denied, 342 U.S. 860 (1951); Jud Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946).

2. Judicial Overrides

Moreover, since its creation, the General Utilities nonrecognition rule has been circumscribed by a variety of judicial doctrines.

a. Tax benefit rule

Under this judicial exception, a taxpayer must take into income amounts previously deducted which are somehow recovered during a subsequent taxable year. Where this rule applies, it overrides §§ 336 and 337. See, e.g., United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983).
b. **Assignment of income doctrine**

This doctrine requires that income be taxed to the person or entity who earned the income. Where applicable, this rule overrides the nonrecognition rules of §§ 336 and 337. See Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961).

c. **Imputed sale doctrine**

A corporation that distributes property to its shareholders with respect to its stock may be required to recognize income upon a subsequent sale of such property by the shareholders if the sale negotiations are conducted by the corporation, or if the corporation's facilities are used to effect the sale. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945); United States v. Cumberland Public Service Co., 338 U.S. 451 (1950). Section 337 eliminates this problem only with respect to sales within a 12-month period following adoption of a plan of complete liquidation.

d. **Liquidation-reincorporation**

Liquidation-reincorporations involve two typical fact patterns:

(1) The shareholder can liquidate the corporation, retain cash and other liquid assets, and immediately reincorporate the operating assets under § 351; or

(2) The corporation may sell the operating assets to a related corporation under § 337, then liquidate and distribute the remaining cash and liquid assets to the shareholder.

The hoped-for tax consequences are capital gain to the shareholder on the removal of the liquid assets, a stepped-up basis for the surviving corporation in the operating assets, and the disappearance of tax attributes. The Internal Revenue Service has challenged such plans generally on three theories:
(1) the transaction constitutes the payment of a dividend;

(2) there has not been a complete liquidation, Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), aff'd, 546 F.2d 423 (4th Cir. 1976); or

(3) the transaction constitutes a reorganization under § 368(a)(1)(D) involving the distribution of boot.

C. Summary of Current Law

1. Nonliquidating Distributions

Section 311(a) provides what is styled as a general rule: gain or loss will not be recognized at the corporate level if a corporation distributes property with respect to its stock. As noted above, however, this nonrecognition general rule was for all intents and purposes reversed in 1984 and now nonrecognition applies only to:

a. Losses (i.e., where the basis of distributed property exceeds its fair market value); and

b. Gains upon certain narrowly defined distributions:

   (1) The qualified dividend exception

   Under § 311(d)(2)(A)(ii), no corporate-level gain will be recognized upon a distribution if all of the following requirements are met:

   (a) The distributee-shareholder is not a corporation;

   (b) The distribution is made with respect to "qualified stock," i.e., stock representing at least 10% in value of the outstanding stock (determined after application of the section 318 attribution rules expanded to include sibling attribution), held by the shareholder for the five-year period preceding the distribution.
(or such shorter period during which the corporation was in existence). § 311(e)(1)(A); and

(c) The distributed assets have been used by the distributing corporation in the active conduct of a "qualified business," i.e., a business actively conducted throughout the five-year period prior to the distribution and a business which was not acquired in a taxable transaction during that period by any person. § 311(e)(2)(B)(i).

(2) Controlled corporation exception

No corporate-level gain will be recognized upon a distribution of stock or an obligation of a controlled corporation by its parent corporation if all of the following requirements are met:

(a) The distributee-shareholder is not a corporation;

(b) The distribution is made with respect to "qualified stock," § 311(e)(2)(A)(ii);

(c) More than 50 percent in value of the outstanding stock of the controlled corporation is distributed by the distributing corporation with respect to qualified stock, § 311(e)(2)(A)(iv);

(d) "Substantially all" of the controlled corporation's assets are assets of one or more "qualified businesses," § 311(e)(2)(B)(i); and

(e) "No substantial part" of the controlled corporation's nonbusiness assets was acquired from the distributing parent corporation in a § 351 transaction or other contribution to capital during the five-year period prior to distribution, § 311(e)(2)(A)(iii).
(3) **Miscellaneous exceptions**

Exceptions to nonrecognition are provided for redemptions to pay death taxes, certain distributions to private foundations, and distributions by certain regulated investment companies in redemption of stock upon the demand of a shareholder. § 311(d)(2)(C), (D) and (E).

The appropriate statutory and judicial override rules described in Part II.B, *supra*, apply to limit nonrecognition under the above exceptions.

2. **Distributions in Partial Liquidation**

a. **Shareholder level treatment**

   (1) **Noncorporate shareholders**

   A noncorporate shareholder receiving a distribution in partial liquidation may qualify for exchange treatment upon the redemption of stock. § 302(b)(4). A distribution in partial liquidation is a distribution meeting the following two requirements:

   (a) the distribution is "not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level)"; § 302(e)(1)(A); and

   (b) the distribution is "pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year," § 302(e)(1)(B).

   The distribution is automatically qualified as "not essentially equivalent to a dividend" if it results in the corporation ceasing to conduct a "qualified trade or business." § 302(e)(2). This latter term is defined in a manner essentially identical to the definition of "qualified business" as used in the qualified
dividend exception for corporate level nonrecognition on nonliquidating distributions. § 302(e)(3).

The redemption may be pro rata among all the shareholders and need not involve an actual surrender of stock to the corporation. § 302(e)(4); Rev. Rul. 81-3, 1981-1 C.B. 125.

(2) Corporate shareholders

A corporate shareholder receiving a distribution in partial liquidation may qualify for exchange treatment only if the distribution qualifies for such treatment under the regular rules of § 302.

b. Corporate level treatment

After 1982, distributions in partial liquidation are subject to corporate level nonrecognition only if:

(1) the distribution meets the requirements for shareholder level exchange treatment under § 302(b)(4), i.e., the distribution meets the definition of partial liquidation in § 302(e) and is received by a noncorporate shareholder, § 311(d)(2)(1)(A); and

(2) the distribution is with respect to "qualified stock", i.e., the distribution is to a 10 percent/5 year noncorporate shareholder, § 311(d)(2)(1)(A).

3. Distributions in Complete Liquidation

In contrast to the general rule for nonliquidating distributions, distributions in complete liquidation generally are nontaxable, subject, however, to recognition imposed by the applicable statutory and judicial override rules described in Part II.B, supra.

a. Section 336

Under § 336(a), no gain or loss is recognized by a corporation on the distribution of its assets in complete
liquidation. The rule applies to all complete liquidations whether the tax consequences of the liquidation to the shareholders are determined under § 331, § 332 or § 333.

b. Outgrowths from § 336

(1) Section 337

Section 337 provides that a liquidating corporation is not taxable on its sale of assets.

(a) Requirements

For § 337 to apply, a corporation must adopt a plan of complete liquidation and, within twelve months after the adoption of the plan, distribute or sell all of its assets (other than assets retained to satisfy creditors' claims). If these requirements are met, the corporation recognizes no gain on loss on the sale or exchange of "property" (specially defined) within the twelve-month period.

(b) Parity

Thus, parity is established between corporate sales preceding liquidation and shareholders sales following liquidation. In either case, only one tax -- on the shareholder in liquidation -- is imposed.

(c) Disparity

The result of § 337 nonrecognition is that the tax results of liquidating sales are much more favorable than those resulting from nonliquidating sales. In either situation, the purchaser takes a cost, i.e., fair market value, basis in the acquired assets. However, in the case of liquidating sales, only recapture and similar items are recognized.
as gain at the corporate level. In contrast, gain is fully recognized at the corporate level in the case of nonliquidating sales of assets.

(2) **Section 338**

A purchaser may acquire a target corporation's business in a taxable acquisition by a purchase of either the corporation's stock or its assets. In the case of an asset purchase, the purchaser takes a cost basis in the assets and no gain or loss is recognized by the target corporation if the sale is made pursuant to § 337. In the case of a stock purchase, however, the target corporation's basis in its assets is not affected by the transaction, no gain or loss is recognized, and no amount is recaptured by the target corporation.

Thus, before enactment of § 338, if the tax cost of recapture did not outweigh the benefit of a step-up in basis of the target corporation's assets, there was a strong incentive for a stock purchase to be structured as an acquisition in conjunction with the liquidation of the target corporation. Section 338 was enacted to eliminate this artificial incentive toward liquidation: where applicable, § 338 permits the purchaser in a taxable stock acquisition to elect to treat the transaction for tax purposes as if the assets of the target corporation had been sold in a hypothetical transaction governed by § 337.

(a) **Effects**

The consequences of a § 338 election are (i) the acquired corporation's basis in all of its assets is stepped up to reflect the price paid for its stock; (ii) the tax attributes of the
acquired corporation are terminated; and (iii) the acquired corporation must recognize recapture and similar items resulting from the deemed sale of its assets pursuant to § 337.

(b) **Parity**

Thus, parity is established between stock purchases and asset purchases with respect to the basis of the target corporation's property.

(c) **Disparity**

Disparity remains with respect to the corporate level tax consequences of nonliquidating asset sales on the one hand and liquidating asset sales (§ 337) and § 338 stock sales on the other hand. In the former case, gain is fully recognized to the selling corporation; in the latter cases, only recapture and similar items are recognized.

Moreover, another disparity remains with respect to the basis consequences of asset sales on the one hand (always a cost basis) and stock sales on the other hand (cost or carryover basis may be elected).

4. **S Corporations**

a. **Nonliquidating distributions**

Gain must be recognized by an S corporation on a nonliquidating distribution of appreciated property. The gain is not taxed at the corporate level but passed through and taxed to the shareholders. § 1363(d). (The gain is not subjected to a double tax upon any subsequent sale of S corporation stock because the shareholders received a basis adjustment corresponding to their previously taxed gain).
b. Liquidating distributions

No gain is recognized by the corporation on a liquidating distribution. § 1363(e).

III. THE GENERAL UTILITIES DEBATE

A. Introduction

1. Literature

The General Utilities doctrine has engendered a prolific commentary debating the many arguments both for and against repeal of the doctrine and suggesting compromise "relief" proposals. A summary of the principal arguments and relief proposals is presented below. An understanding of these arguments is useful in that they identify the planning opportunities foreclosed by repeal of the General Utilities doctrine and suggest what opportunities may remain.

Repeal of General Utilities, 37 Tax Lawyer 641 (Spring 1984).

2. **History**

Over the years, a number of extensive analyses of Subchapter C have been undertaken and recommendations for reform made. For purposes of this outline, the most significant and recent of these are:


b. ABA Section of Taxation Task Force Report, Income Taxation of Corporations Making Distributions with Respect to Their Stock, 37 Tax Lawyer 625 (1984); and


B. **Arguments Pro and Con**

1. **Arguments in Favor of Repeal**

   a. **The doctrine impairs the theoretical integrity of the tax system**

      (1) **Basis adjustment rules**

      The ability of a distributee (or purchaser) to acquire property with a cost basis without requiring the property's transferor to fully recognize gain is inconsistent with the Code's usual treatment of tax-free transfers. In such cases, a carryover basis generally is required.

      (2) **Two-tier system**

      The General Utilities doctrine represents an unjustified anomaly in an unintegrated system based upon the separate taxation of corporations and shareholders.
(3) **Liquidation preference**

There appears to be no sound policy reason for favoring liquidations with generous tax results. A tax system that imposes tax upon current operations at both the shareholder and corporate levels should treat liquidations in the same way.

b. The existence of the doctrine engenders statutory complexity and distorts the structure of transactions

(1) **Statutory complexity**

The tax avoidance possibilities created by the existence of the General Utilities doctrine have led to the enactment of an often bewildering array of statutory provisions designed to check perceived abuses. The collapsible corporation provisions of § 341 and the consistency rules of § 338 are often cited as examples of the extraordinary complexity spawned by the General Utilities doctrine. Moreover, many of the statutory and judicial override rules described in Part II.B, supra, are in part necessitated by the General Utilities doctrine. Repeal of the doctrine would enormously simplify Subchapter C, producing a concomitant reduction in uncertainty in planning transactions.

Note: Despite proposing the repeal of the General Utilities rule, the House and conference versions of H.R. 3838 do not repeal either § 341 or § 338's consistency rules.

(2) **Distortion of transactional structures**

The existence of tax avoidance possibilities creates powerful pressure in favor of particular types of transactions; makes the tax system non-neutral and subject to manipulation; and enhances disrespect for the system. Moreover, the preference
for liquidations may encourage merger and acquisition activity.

c. **Misallocation of purchase price**

The conflict of interest that ordinarily exists in a taxable transaction between the seller and the purchaser of assets guarantees a fair allocation of the purchase price to the individual assets involved in the transaction. The seller will seek to place a low value on inventory and other ordinary income assets and a high value on goodwill and other capital assets, i.e., to minimize ordinary income and maximize capital gain. The buyer has a contrary interest. Where no gain is recognized, however, the seller's incentive to resist the buyer's allocation is eliminated because the seller is indifferent to the allocation. The result is that purchase price will be misallocated among the assets involved in the transaction.

Note: This argument becomes largely moot in the absence of preferential taxation of capital gains, as proposed by H.R. 3838.

d. **Revenue**

The General Utilities doctrine represents the 22nd largest tax expenditure. See Yin, supra, 31 Tax Notes at 1116-1117.

2. **Arguments Against Repeal**

a. **Partial integration of corporate and individual income taxes**

The General Utilities doctrine at least partially mitigates the double taxation of corporation income.

b. **Distributions are not realization events**

The transfer of assets in kind out of corporate solution does not realize income to the corporation.

c. **Defeat of expectations**

It would be unfair to impose a double tax on people who incorporated on the
assumption that the eventual sale of the business would be subject to only a single tax.

d. Inconsistency with § 351

Section 351 permits taxpayers to form a corporation without incurring tax upon the contribution of assets to the new corporation. This rule facilitates the incorporation of assets. A nonrecognition rule is similarly justified in complete liquidations to facilitate the disincorporation of assets. Without such a rule, barriers to the exit of the corporate form exist, and investments may be artificially locked into a particular form.

e. Preincorporation gain

Under § 351, the corporation takes a carryover basis in the contributed assets. As a result, a double tax would be imposed upon any preincorporation appreciation in the assets if the General Utilities doctrine were repealed.

d. Impact upon small, closely held businesses

The substance of this argument is that a double tax upon the "largely inflationary" gains on long-held assets of a small business at the time of its liquidation is simply too high a price to exact. See Staff Report, supra at 6.

g. Discouragement of C corporations

A full double tax upon corporate income would discourage businesses from utilizing the C corporation's form.

Note: The differential in rates imposed on corporations and individuals proposed by H.R. 3838 may well eclipse whatever effect the repeal of the General Utilities doctrine may have upon the decision to utilize the C corporation form.

C. Relief Proposals

The combined "double tax" burden on the appreciation of corporate assets resulting from repeal of the
General Utilities doctrine, ignoring recapture items, would be 42.4% under current rates and 52.5% under the rates proposed by H.R. 3838. Accordingly, many proposals to repeal the General Utilities doctrine have been linked with recommendations for relief from the double tax. These recommendations are briefly summarized below:

1. **Dividends Paid Deduction**

The House version of H.R. 3838 provided a deduction for dividends paid by corporations equal to 10 percent of earnings that have been subject to the corporate tax. In connection with proposing the repeal of the General Utilities rule, the House acknowledged that "some relief from the two-tier tax on corporate earnings should be provided" and cited the dividends paid deduction as such a partial relief measure, mitigating the consequences of the repeal of the General Utilities rule. Ironically, the conference agreement adopted the House's proposal to repeal the General Utilities rule but rejected the dividends paid deduction.

2. **Shareholder Credit**

The ALI Report suggested that shareholders should be allowed a tax credit equal to the shareholder's share of the corporate level tax in liquidation on long-held capital and § 1231 assets.

3. **Nonrecognition Plus Basis Adjustment**

It has been suggested that a shareholder should be allowed nonrecognition upon receipt of distributed property if the shareholder's basis in his stock is substituted as the basis of the distributed assets. See Lewis, *A Proposed New Treatment of Corporate Distributions and Sales in Liquidation*, House Committee on Ways and Means, 3 Tax Revision Compendium 1643 (1959). Another possibility is a carryover basis rule similar to that which governs other tax-free transactions.

4. **Specific Exemptions**

Some proposals have suggested that particular corporate assets be exempted from corporate-level gain recognition:
a. Historic capital assets;
b. "Assets of small, closely held businesses;
c. Goodwill or going-concern values; or
d. Preincorporation appreciation.

IV. H.R. 3838: THE SHAPE OF GENERAL UTILITIES REPEAL

A. House Bill and Conference Agreement

1. House Bill

a. On December 17, 1985, H.R. 3838 was passed by the House. The House Bill provided for repeal of the General Utilities doctrine subject to three exceptions:

(1) distributions by a controlled subsidiary in a liquidation under § 332;

(2) distributions with respect to "qualified stock" (i.e., stock held by long-term noncorporate shareholders) where the corporation is an "active business corporation" -- a rule paralleling the exception provided for nonliquidating distributions, § 311(d)(2)(A)(ii); and

(3) distributions and exchanges involving property that may be received tax-free under the reorganization provisions of the Code.

b. The Senate Bill did not provide for the repeal of the General Utilities rule.

2. Conference Compromise

a. On August 16, 1986, the House-Senate Conferees to H.R. 3838 reported an agreement upon a bill which, if passed, would repeal the General Utilities doctrine subject to a number of limited exceptions and certain grandfather provisions. The Conference Report was issued on September 18, 1986. The conference agreement passed the House on September 25, 1986 (subject to a resolution calling for a series of corrections, H. Con. Res. 395) and passed the Senate on September 27, 1986.
b. In overview, the conference agreement provides that gain or loss generally is recognized by a corporation on the liquidating distribution or sale of its assets, subject to three exceptions:

(1) distributions of property to the extent there is nonrecognition under the tax-free reorganization provisions of the Code;

(2) sales and distributions of certain recently-acquired loss property; and

(3) distributions by a controlled subsidiary in a liquidation under § 332.

c. The conference agreement also provides for the following related changes to present law:

(1) deletion of the reference to § 337 in § 338 and expansion of the § 338(h)(10) election to situations in which the selling corporation owns 80 percent of the value and voting power of the subsidiary, but does not file a consolidated return;

(2) repeal of § 333, the one month liquidation rule;

(3) repeal of the § 311(d)(2) exceptions to gain recognition:

(a) repeal of the present law qualified stock exception from gain recognition for partial liquidations and qualified dividends (§ 311(d)(2)(A)), (necessitated by the conference agreement's failure to adopt the House Bill's "qualified stock" exception for liquidating distributions);

(b) repeal of the present law exception for nonliquidating distributions of controlled corporation stock (§ 311(d)(2)(B)); and

(c) repeal of the present law exceptions for nonliquidating distributions in connection with
the payment of death taxes
($311(d)(2)(C)) and in con-
nection with certain redemptions
of private foundation stock
($311(d)(2)(D)); and

(4) imposition of a corporate level tax
where a C corporation elects to con-
vert to an S corporation after
December 31, 1986, and sells or
distributes property within 10 years
after the date on which the S election
took effect where such property had
"built-in gain" at the time of the
conversion.

d. All of these provisions are discussed in
detail in the following section.

B. General Rules and Exceptions

1. Treatment of Liquidating Distributions:
New § 336

a. Under the statute, the general rule of old
§ 336(a), (i.e., that no gain or loss is
recognized on corporate distributions of
property in complete liquidation) would be
reversed. Under new § 336(a), a corpora-
tion would recognize gain or loss on the
distribution of property in complete
liquidation as if the property were sold
for its fair market value to the
distributee shareholders. Compare
§ 311(d)(1). Certain exceptions and
special rules, discussed below, are
provided.

b. Moreover, old § 337 is repealed and no
corresponding substantive substitute is
provided. Liquidating sales would accord-
ingly be treated no differently from sales
generally.

c. Liabilities taken subject to or
assumed

(1) Under new § 336, if property is
distributed subject to a liability, or
a liability is assumed in connection
with the distribution, the property
would be deemed to have a fair market
value at least equal to the liabil-

37
ity. New § 336(b). The recourse or nonrecourse character of the liability is, apparently, irrelevant. Compare § 7701(g) and § 311(c).

(2) Query: If the shareholder assumes an unsecured liability in connection with the distribution, how should such liability be allocated among the distributed assets in order to determine the distributing corporation's gain?

d. Exception for tax-free reorganizations

(1) New § 336(c)

New § 336(c) provides that gain or loss will not be recognized with respect to any distribution of property by a corporation to the extent there is nonrecognition of gain or loss to the recipient under the tax-free reorganization provisions of the Code (part III of Subchapter C).

(2) Technical correction

The House Report noted that "under present law it is not entirely clear whether or not the nonrecognition provisions applicable to corporate liquidations apply to a corporate reorganization." (Citing FEC Liquidating Corporation v. United States, 548 F.2d 924 (Ct. Cl. 1977) and General Housewares Corporation v. United States, 615 F.2d 1056 (5th Cir. 1980)). H. Rep. No. 426, 99th Cong., 1st Sess. 898 (1985). New § 361 appears to reiterate § 336(c) in providing that § 336 and § 337 are not applicable to transfers pursuant to a plan of reorganization. New § 361(b)(1).

e. Limitations on the recognition of losses

Under the new statute's general rule, losses would be recognized by a corporation on liquidating distributions but not on nonliquidating distributions. Compare new § 336(a) with § 311(a). The conferees were concerned that the loss recognition rule
for liquidating distributions might be used by taxpayers to "create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contribution of built-in loss property." Conf. Rep. No. 841, 99th Cong., 2d Sess. 200 (Sept. 18, 1986). Accordingly, three provisions limiting the recognition of losses were included in the new statute. New § 336(d).

(1) **Distributions to a related person**

No loss can be recognized by a liquidating corporation with respect to any distribution of property to a related person. New § 336(d)(1). One exception is provided.

(a) **Exception**

Loss may be recognized on a liquidating distribution to a related person only if:

(i) the distribution is pro rata to all shareholders, and

(ii) the distributed property was not acquired during the five years preceding the distribution in a § 351 transaction or as a contribution to capital.

(b) **Related person**

A related person for purposes of this provision is determined by reference to § 267, i.e., generally any shareholder owning directly or indirectly more than 50 percent in value of the distributing corporation's stock.

(c) **Operation of the rule**

This provision operates to disallow any loss on property distributed to a related person whether or not there existed "built-in loss" at the time the property was acquired.
Example: A shareholder contributes property having built-in gain to a corporation. The property subsequently declines in value. If the property is distributed to a related party non-pro rata or within 5 years of the contribution, the corporation's loss is disallowed.

(d) **Use of disallowed loss by recipient**

Query: If the recipient of property upon which a loss has been disallowed under this provision subsequently sells the property for a gain, may he reduce such gain up to the amount of the disallowed loss pursuant to § 267(d)? As § 267(d) now reads, a disallowed loss may be used in this fashion only if disallowed under § 267(a)(1). It would seem that a loss disallowed under proposed § 336(d)(1) should similarly be permitted to reduce subsequent gain.

(2) **Basis adjustment where prohibited purpose exists**

If a principal purpose of the contribution of property to a corporation in advance of its liquidation is to recognize a loss upon the sale or distribution of the property and thus reduce or eliminate corporate level gain, new § 336(d)(2) requires that the basis of such property in the hands of the corporation be reduced by the amount of the inherent loss on the date of the contribution (i.e., the excess of basis over fair market value on such date).

(a) **Presumed prohibited purpose: 2-year rule**

Any property acquired during the two years prior to the adoption of a plan of complete liquidation in a § 351 transaction or as a
contribution to capital is presumed to have been contributed to the liquidating corporation with the prohibited purpose. New § 336(d)(2)(B)(ii).

Note: The legislative history characterizes this rule as applying to any contributions during the two-year period prior to adoption of the liquidation plan "or thereafter." Conf. Rep. No. 841, supra, at II-200 (emphasis added).

Regulations are authorized which may provide exceptions to the presumed prohibited purpose rule. The conferees suggest three such exceptions to be included in regulations:

(i) the contribution of property where there is a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises;

(ii) the contribution of the assets of a trade or business (or line of business) where the contributed business, as distinguished from a portion of its assets, is not disposed of immediately after the contribution; and

(iii) a corporation's acquisition of property during its first two years of existence.

(b) Loss recapture rule

Losses disallowed for a prior year under this provision may be accounted for in either of two ways:

(i) the corporation may file an amended return for the
taxable year in which the loss was reported; or

(ii) the corporation may recapture the loss on the current year's return -- the year a plan of liquidation was adopted -- and such recapture will be the lesser of built-in loss on the date the loss property was contributed or the loss actually recognized on the disposition of the loss property. New § 336(d)(2)(C).

(c) Ambiguities

Query: It is possible that both this provision and new § 336(d)(1) may apply in the same circumstances to disallow a loss, e.g., a distribution to a related person of loss property contributed to the corporation within two years prior to the adoption of a plan of liquidation. Which loss limitation provision controls?

Query: May the loss disallowed under this provision be utilized to reduce any gain realized on the subsequent disposition of the property by the distributee or purchaser? Cf. § 267(d).

(3) Loss limitation in § 332 liquidations

No loss may be recognized to a liquidating corporation on any distribution in a § 332 liquidation. New § 336(d)(3). See IV.B.2.c., infra. This essentially is a non-recognition rule for distributions to minority shareholders.

f. Distributions or sales of subsidiary stock: § 336(e)

(1) Election to treat as asset transfer

New § 336(e) provides that, under regulations to be issued by the Service, no gain or loss will be
recognized upon the sale, exchange, or distribution of a controlled corporation's stock by a parent corporation if the parent chooses to elect to treat such sale, exchange or distribution as a "disposition of all of the assets" of the controlled corporation. A controlled corporation, for these purposes, is one whose stock is owned in accordance with requirements of § 1504(a)(2), i.e., the electing parent owns 80 percent of the value and voting power of the corporation.

Note: It appears that this election will not be available until regulations are issued by the Service.

Query: May same of the stock be sold and some of the stock be distributed?

(2) **Relationship to § 338(h)(10)**

New § 336(e) applies principles similar to those of § 338(h)(10) to taxable sales or distributions of controlled corporation stock. As distinguished from the § 338(h)(10) election (an election whose availability is expanded under the conference agreement, see part IV. B.3.c., infra), the election under new § 336(e) may be made regardless of whether the buyer makes a § 338 election and may apply in the case of a distribution of the stock of a controlled corporation's stock.

Query: Will the buyer or distributee obtain a step-up in the basis of the subsidiary's assets if the selling or distributing corporation makes a § 336(e) election?

(3) **Apparent purpose: avoidance of potential triple tax**

Example: P owns all of the stock of S, and P liquidates, distributing the stock of S to its sole shareholder, A, an individual. S later liquidates as well. A triple tax potentially may be imposed:
(a) P recognizes gain upon the liquidating distribution of S stock to A, § 336(a);

(b) A recognizes gain upon the disposition of his P stock in liquidation, § 331; and

(c) S recognizes gain upon its subsequent liquidating distributions of assets to A, § 336(a).

This triple tax may be reduced to a double tax by the use of the § 336(e) election pursuant to which P may treat the distribution of S stock to A as a distribution of S assets instead. This result depends, however, upon S receiving a step-up in the basis of its assets, a result not expressly provided for in the statute. Note further that the § 336(e) election apparently will not be available until regulations are issued by the Service. Until such time, the above transaction would be subject to triple tax.

(4) Regulations

The conferees indicate that they expect "regulations under this elective procedure will account for appropriate principles that underlie the liquidation - reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of § 368(c)(2), it may be appropriate to provide special rules for such corporation's § 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed." Conf. Rep. No. 841, supra, at II-204.
Example: B, an individual, owns all of the stock of P. P, in turn, owns 80 percent of the stock of S but does not file a consolidated return. The other 20 percent of S stock is owned by A, an individual. P distributes its 80 percent of the stock of S to B. P then makes a § 336(e) election. The transaction therefore must be treated as a distribution of S assets.

Query: To whom is the gain on the deemed asset distribution recognized: P or S? If the gain is taxed to P, A receives a windfall: a step-up in the basis of S assets at no tax cost to S. If the gain is taxed to S, A suffers an unfair detriment: the value of his stock is reduced by the tax liability imposed on S. It is true that S obtains a step-up in the basis of its assets but the tax benefits flowing from such a step-up may not materialize currently (e.g., a large step-up in the basis of non-depreciable assets) or be useless to A currently (e.g., A intends to sell his stock before the tax benefits accrue).

2. Exception for § 332 Liquidations: New § 337

New § 337(a) would create an exception from gain or loss recognition for liquidating distributions to an 80-percent distributee. Under § 334(b)(1), the controlling corporate shareholder will take a carryover basis in the distributed property.

a. 80-percent distributee

(1) An 80-percent distributee is "only the corporation which meets the 80-percent stock ownership requirements specified in § 332(b)." New § 337(c).

(2) The stock ownership requirements of § 332(b) are slightly amended by a technical correction contained in the conference agreement. See § 1804(e)(6) of the Act. New
§ 332(b)(1) would require an ownership percentage "meeting the requirements of § 1504(a)(2)," i.e., 80 percent of voting power and value.

(3) Under the rule of § 332(b)(1), the distributee must possess the requisite ownership percentage "on the date of the adoption of the plan of liquidation" and must continue to possess the requisite percentage "at all times until the receipt of the property."

b. Minority shareholders

(1) Distribution in a § 332 liquidation

Where minority shareholders also receive property in a § 332 liquidation, the distribution is treated in the same manner as a nonliquidating distribution in redemption under § 311. Thus, gain but not loss may be recognized to the distributing corporation. The loss nonrecognition rule of § 311(a) prevents the liquidating corporation from selectively recognizing losses by distributing loss property to minority shareholders and gain property to the 80-percent distributee.

(2) Comparison with House Bill rule

This rule represents a modification of the rule proposed by the House Bill. Under the House Bill, only a percentage of the gain realized on the distribution of appreciated property would have been recognized, a percentage equal to the percentage of stock held by minority shareholders, regardless of whether the minority shareholders received such appreciated property. In contrast, under the conference agreement, the amount of gain recognition would be determined by reference to the property actually received by minority shareholders; if minority shareholders receive all of the liquidating corporation's appreciated property, all of such gain would be recognized, whereas if the
minority shareholders receive only cash, no gain would be recognized to the liquidating corporation.

(3) Ambiguity in the new statute

Example: P corporation purchases 80 percent of the stock of T and P does not make a § 338 election. An individual, A, owns the remaining 20 percent of T stock. P and T merge in an upstream merger pursuant to which A receives P stock. The merger fails to satisfy the continuity-of-interest requirement and therefore the transaction is taxable with respect to the minority shareholder. However, P receives T's assets in a liquidation to which § 332 applies and T therefore recognizes no gain or loss with respect to the distribution of 80 percent of its assets. See Kass v. Commissioner, 60 T.C. 218 (198-).

Queries: Does new § 336(a) apply to T? Is there a deemed distribution of 20 percent of all assets to A? If so, what assets are deemed distributed to A?

c. Losses

New § 337(a) provides that no loss will be recognized to the liquidating corporation upon a distribution to the 80-percent distributee. This loss nonrecognition rule for § 332 liquidations is extended to distributions to minority shareholders as well by new § 336(d)(3) which provides that "no loss shall be recognized to the liquidating corporation on any distribution in such liquidation." Thus, distributions in a § 332 liquidation can only trigger the recognition of gain (with respect to distributions to minority shareholders) but never loss.

d. Tax-exempt distributees

Gain or loss will be recognized if the 80-percent distributee is a tax-exempt organization (other than a cooperative described in § 521). New § 337(b)(2).
(a) Exception for use in unrelated business

Gain or loss will not be recognized if the tax-exempt organization uses the distributed property in an unrelated trade or business immediately after the distribution. New § 337(b)(2)(B).

(b) Later recapture

If the property later ceases to be used in an unrelated trade or business of the organization, the organization will be taxed at that time. The tax will be on the lesser of (i) the built-in gain in the property at the time of the distribution, or (ii) the difference between the adjusted basis of the property and its fair market value at the time the property's use in the unrelated business ceases. New § 337(b)(2).

e. Foreign corporations

Nonrecognition also is denied under the § 332 liquidation exception where the controlling corporate shareholder is a foreign corporation. New § 367(e).

f. Indebtedness of subsidiary to parent

A transfer of property from a subsidiary to its parent in satisfaction of the subsidiary's indebtedness (which indebtedness existed on the date of adoption of a plan of liquidation to which § 332 applies) will be treated as a liquidating distribution subject to the rules of new §§ 336 and 337. New § 337(b)(1). This provision is essentially identical to the provision of old § 332(c) which is repealed by H.R. 3838.

3. Amendments to § 338

a. Deletion of the reference to § 337

The conference agreement amends § 338(a) by striking out the reference to § 337 so that the target corporation now simply will be
treated as having made a deemed sale of its assets without the nonrecognition protection afforded by old § 337. The target corporation therefore will recognize gain on the deemed sale of its assets.

b. Elimination of § 338's utility

There would exist virtually no circumstances under which a § 338 election would be advisable.

Example: T is a publicly held holding company that owns all of the stock of S-1, another holding company. In turn, S-1 owns all of the stock of S-2, an operating company. All of T's stock is sold to P and P makes a § 338 election. The result will be a deemed sale by T of the S-1 stock pursuant to which gain is recognized by T and a deemed sale by S-1 of the S-2 stock pursuant to which gain is recognized by S-1. The same gain is recognized twice. Gain then is recognized a third time by S-2 on the deemed sale of its assets.

One exception is any situation in which a § 338(h)(10) election is possible and advantageous in light of the relationship between inside and outside basis, tax attributes of the target corporation, and the tax situation of the buyer.

c. Expansion of the § 338(h)(10) election

The conference agreement retains § 338(h)(10) of present law which, in certain circumstances, permits a corporate purchaser and a seller of an 80-percent controlled subsidiary to elect to treat the sale of the subsidiary's stock as if it had been the sale of the underlying assets. In such a case, gain would be recognized (on the deemed sale of assets) to the selling consolidated group.

Old § 338(h)(10) requires that the selling corporation and its target subsidiary must be members of an affiliated group filing a consolidated return for the taxable year that includes the acquisition date. New § 338(h)(10)(B) would expand this election to situations in which the selling
corporation owns 80 percent of the value and voting power of the subsidiary, but does not file a consolidated return.

d. Problem with new § 338(h)(10): minority shareholder

Example: X corporation owns 80 percent of the stock of T but does not file a consolidated return. The other 20 percent of T is owned by A, an individual. X sells its 80 percent stake in T to P corporation. X then makes a § 338(h)(10) election, so that the transaction will be treated as a deemed sale of T's assets.

Queries: To whom is the gain on the deemed asset transfer recognized: X or T? If the gain is taxed to X, A receives a windfall: a step-up in the basis of T's assets at no tax cost to T. If the gain is taxed to T, A suffers an unfair detriment: the value of his stock is reduced by the tax liability imposed on T. Compare discussion of new § 336(e) at part IV.B.1.d.

e. Old § 338(c) and § 338(h)(12) are repealed.

4. Repeal of § 333

a. The conference agreement would repeal § 333, eliminating the one-month liquidation option of present law.

b. Because liquidating distributions are generally taxable to shareholders under § 331, the liquidation of a corporation owning appreciated real estate but having minimal profits, and thus little cash, may not be feasible. The shareholder would recognize gain on the receipt of the property but would receive no cash with which to pay the tax. If a shareholder intends to continue to hold the property in unincorporated form, generation of the necessary cash by means of a sale of the property would be undesirable. In the absence of old § 333, which allowed for the deferral of gain through a substituted basis mechanism, the shareholder would have been compelled to continue to operate in corporate form.
c. However, in the absence of the General Utilities rule, a § 333 election would produce highly unfavorable results for most taxpayers. Under § 333, an electing shareholder generally is obliged to recognize, as ordinary income, his ratable share of the liquidating corporation's E&P. Current E&P generally is increased to the extent of gain recognized on the liquidating distribution. Accordingly, there rarely would be deferral under § 333 in absence of the General Utilities rule because the recognition of corporate level gain would produce E&P. Only in the case of a corporation having a very large historical deficit in E&P -- sufficient to offset gain recognized upon liquidation -- would a § 333 election be advantageous. Thus, the repeal of § 333 deprives only those shareholders holding stock in a corporation with a large historical deficit in E&P of the beneficial use of a § 333 election.

5. Treatment of Nonliquidating Distributions: New § 311(b)

a. Repeal of the nonrecognition exceptions

Under old § 311(d), gain generally is recognized upon the nonliquidating distribution of appreciated property. See part II.C.1, supra. Five exceptions were provided. § 311(d)(2)(A)-(E). Four of these exceptions -- distributions with respect to qualified stock, distributions of controlled corporation stock, distributions to pay death taxes, and distributions to certain private foundations -- are repealed under the new statute. New § 311(b).

The repeal of these exceptions is intended to conform the treatment of nonliquidating and liquidating distributions. Nonrecognition would remain available only for certain distributions by regulated investment companies. See new § 852(b).
b. Distributions in reorganization:
New § 361

(1) Receipt of boot

Under old § 361, gain or loss is not recognized by a transferor (acquired) corporation on the transfer of assets pursuant to a reorganization, unless money or other property (boot) is received and not distributed. New § 361(a) provides that the transferor corporation does not recognize gain or loss on the receipt of boot, without regard to whether the boot is distributed. New § 361(b)(2) further provides that the transferor corporation takes a carryover basis in the boot received, adjusted for any gain recognized by the acquiring corporation. The effect of this latter provision is to give the transferor a fair market value basis in most cases because the acquiring corporation generally must recognize gain when appreciated property is transferred as boot.

(2) Distribution of boot and other property

New § 361(c) provides that the transferor corporation generally will recognize gain upon the distribution of property (including boot) pursuant to a plan of reorganization (other than stock or securities, see (3) below). The result will be that the distribution of retained property will generally result in gain recognition and the distribution of boot will not (because the transferor corporation obtained a fair market value basis under new § 361(b)(2)).

(3) Distribution of stock or securities

New § 361(b)(3) apparently provides that the transferor corporation will not recognize gain upon the "disposition" of stock or securities received in the reorganization. Thus, no gain would be recognized on the
distribution of such stock, the sale of such stock, or, expressly, upon the distribution of such stock to creditors. New § 361(b) (flush language)

(4) **Effective date**

New § 361 would be effective for plans of reorganization adopted after the date of enactment of H.R. 3838.

c. **Distributions under § 355**

The recognition provision of new § 311(b)(1) applies only to distributions "to which subpart A applies." Subpart A does not include § 355, relating to corporate divisions. Accordingly, it appears that § 355 distributions would not be subject to corporate level tax.

6. **S Corporations That Were Formerly C Corporations**

Under proposed § 1374, an S corporation that formerly was a C corporation must pay a corporate level tax (the highest rate of tax specified in § 11(b)) on the lesser of "recognized built-in gains" or the corporation's taxable income for the year if it were not an S corporation. New § 1374(a) and (b)(1).

**Note:** New § 1374 will not apply to any corporation which always was an S corporation throughout its existence.

a. **Recognized built-in gains**

Built-in gain is the amount of gain inherent in the corporation's assets as of the date of its conversion from C corporation to S corporation status.

Recognized built-in gain is any built-in gain recognized during the "recognition period," the 10-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. New § 1374(d)(2) and (3).
b. **Burden of proof on S corporation**

   (1) **Presumption**

   Gain on the disposition of any asset by an S corporation within the 10-year period will be presumed to be built-in gain unless the corporation can establish that the asset was acquired or the appreciation accrued after the corporation's conversion to S corporation status. New § 1374(d)(2).

   (2) **Ceiling**

   However, the aggregate gain recognized by a S corporation during the 10-year period is limited to the aggregate built-in gain on all assets held at the time of conversion to S corporation status. New § 1374(c)(2). (This may constitute a dubious "protection" for S corporations in that the same difficulties of proof probably will exist with respect to establishing the amount of the aggregate built-in gain "ceiling" as existed with establishing the amount of built-in gain for a particular asset disposition).

c. **Offsets to tax on recognized built-in gains**

   (1) **C attributes**

   The corporation will be permitted to utilize all of its unexpired subchapter C tax attributes in computing the amount of the tax on recognized built-in gains, e.g., NOLs, capital loss carryovers, minimum tax carryover credits. Conf. Rep. No. 841, supra, at II-203; New § 1374(b).

   (2) **Reduced pass-thru**

   Moreover, the amount of recognized built-in gain passed through to shareholders is reduced by a proportionate share of any tax imposed at the corporate level upon such gain. New § 1366(f)(2).
Reorganizations excepted

In addition, the tax on recognized built-in gains will not apply to any distribution to the extent it consists of property permitted to be received tax-free under the reorganization provisions. New § 1363(e).

d. Effective date

New § 1374 will generally be effective with respect to S elections made after December 31, 1986. For S elections made prior to such date, present law will apply.

(1) Pre-effective date elections

For S corporations that were formerly C corporations whose election predates December 31, 1986, the following rules will apply:

(a) old § 1374, providing for a corporate level tax on net capital gains realized within three years of the S election if the gains in any year exceed $25,000 and exceed 50 percent of taxable income.

(Note: Final regulations under old § 1374 recently were issued by the Service. T.D. 8104 (September 25, 1986)).

(b) § 1363(d), providing for corporate level recognition (but not tax) upon the nonliquidating distribution of appreciated property; and

(c) old § 1363(e), providing for corporate level nonrecognition upon liquidating distributions of appreciated property.

(2) Post-effective date elections

For S corporations that were formerly C corporations electing after December 31, 1986, the following rules would apply:
(a) new § 1374, providing for corporate level taxation of built-in gain on dispositions (sales or distributions) of assets during the 10 year period following the election;

(b) § 1363(d), providing for corporate-level recognition on nonliquidating distributions, a provision which apparently continues to apply under the new statute only to former C corporations after the 10-year period ends, and to new S corporations; and

(c) § 336(a), providing for corporate level recognition on liquidating distributions (old § 1363(e) is repealed).

C. Effective Date and Grandfather Provisions

1. General Effective Date

The provisions repealing the General Utilities rule generally will apply to:

a. liquidating sales and distributions made after July 31, 1986;

b. § 338 elections where the acquisition date is after December 31, 1986; and

c. any distributions not in complete liquidation made after December 31, 1986.

2. Grandfather provisions

Grandfather provisions are provided for four categories of transactions.

a. Liquidations completed before January 1, 1987

The new provisions would not apply to liquidations completed before January 1, 1987 (regardless of when the plan of liquidation is adopted) or deemed liquidations pursuant to § 338 where the acquisition date occurs before January 1, 1987.
b. Certain actions taken before August 1, 1986

(1) Where any of the following events occurred before August 1, 1986:

(a) a plan of liquidation was adopted;

(b) a binding written contract was entered into for the sale of:

(i) a quantity of the company's stock constituting a qualified stock purchase under § 338;

(ii) a majority of the company's voting stock; or

(iii) substantially all of the company's assets;

and the liquidation is completed before January 1, 1988 (or the § 338 acquisition date occurs before 1988), the rules of the new statute do not apply.

(2) The term "substantially all of the assets" generally will mean 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets. It will also include contracts which under applicable state law constitute sales of substantially all assets requiring shareholder approval.

c. Small, closely held businesses

Relief is provided for small, closely held companies on sales and distributions completed before January 1, 1989. This relief provision would not, however, apply to ordinary income and short term gain property. § 633(d) of the Act.

(1) Small, closely held companies

Such companies are those not exceeding $5 million in value and more than 50 percent of whose stock is owned
directly or indirectly by no more than 10 individuals. Although the proposed statutory language does not include such a requirement, the legislative history indicates that such stock must have been owned for five years or longer. Conf. Rep. 841, supra, at II-206. This conflict is corrected by H. Con. Res. 395 (74) which provides that such stock must have been held "for the lesser of (i) the 5-year period ending on the date of adoption of the plan of complete liquidation, or (ii) the period during which the corporation (or any predecessor) was in existence."

(2) **Phase out**

Relief phases out for such closely held companies with value between $5 and $10 million. Value is determined according to the higher of (a) the corporation's value on August 1, 1986, or (b) its value as of the date of adoption of a plan of liquidation (or the date of distribution in the case of nonliquidating distributions).

(3) **§ 311(b), § 338 and § 1374**

Nonliquidating distributions by corporations qualifying under this grandfather provision are not subject to new § 311(b) until January 1, 1989. H. Con. Res. 395 (75). This grandfather provision applies as well for purposes of deferring the coverage of the rules of new § 338 and new § 1374. § 633(d)(7) and (8) of the Act.

d. **Liquidations grandfathered under House Bill**

Liquidations are grandfathered which were grandfathered under the special definitions of the House Bill if the liquidations are completed by January 1, 1988. The general transitional rule of the House Bill was that the new rules did not apply to distributions or sales or exchanges made pursuant to a plan of liquidation adopted
V. EFFECTS, IMPLICATIONS AND PLANNING

A. Effect of Repeal

1. Discouragement of Mergers and Acquisitions

There is disagreement whether the General Utilities rule is a significant factor fueling the recent spate of leveraged buy-outs and other merger and acquisition activity. One merger and acquisition specialist suggests that the rule merely affects price and, without the rule, "a few marginal deals won't get done." See Sheppard, 30 Tax Notes at 86 (January 13, 1986). The House Report accompanying H.R. 3838, however, stated that "the General Utilities rule may be responsible, at least in part, for the dramatic increase in corporate mergers and acquisitions in recent years." H. Rep. No. 426, 99th Cong., 1st Sess. 282 (Dec. 7, 1985).

2. Discouragement of the Use of the C Corporation

With the tax rate discrepancy created by proposed H.R. 3838 -- the maximum corporate rate, 34 percent, will exceed the maximum individual rate, 28 percent, for the first time -- and the repeal of the General Utilities rule, there will be few instances in which a business would be advised to utilize the C corporation form, especially in view of the fact that the "nontax advantages of incorporation are dubious at best." Lee, supra, 31 Tax Notes at 1377 n.39.

3. Asset Purchases: No Opportunity for Carryover Basis

a. The new statute would create a disparity between stock purchases and asset purchases. In the case of stock purchases, the buyer has two alternatives:

(1) The buyer may obtain a step-up in the basis of the underlying assets by making a § 338 election; or
(2) the buyer may take a carryover basis in the underlying assets by not making such an election.

b. In the case of an asset purchase, the buyer is compelled always to accept a step-up in the basis of the acquired assets. No carryover basis election is provided in the new statute.

c. Note: A carryover basis election for both asset and stock purchases would be made available under the statutory reform proposed by the Senate's 1985 Staff Report.

B. Planning Strategies: Before the New Provisions Are Effective

1. Liquidations

Liquidations completed prior to January 1, 1987 may still take advantage of the General Utilities rules.

Moreover, prior to December 31, 1986, shareholders may still receive preferential capital gain treatment upon the disposition of their shares in complete liquidation. § 331. For individuals, gain would be taxed at only 20 percent. After December 31, 1986, such gain would be subject to tax at 28 percent. The same consideration is applicable to distributions in partial liquidation as well. § 302(b)(4).

Note: It may be desirable for small closely held companies to liquidate before the end of 1986 despite the existence of a special grandfather provision extending the effective date of the new rules for such corporations to January 1, 1989. The reason is that all property distributed in liquidation prior to January 1, 1987, is protected from the application of the new rules while under the special grandfather provision for small corporations, distributions of ordinary income and short term capital gain property are not protected.

2. S Corporation Conversion

If a C corporation is eligible, it should file an election before December 31, 1986 to convert to an S corporation. Liquidating distributions of appreciated property will then not be subject
to corporate level recognition, even though they occur after January 1, 1987. Old § 1363(e). Nonliquidating distributions would, however, continue to be subject to corporate level recognition (but not tax). § 1363(d).

Liquidating sales may be subject to corporate level tax under old § 1374 but such tax can be avoided if an installment sale schedule provides for no more than $25,000 of gain in any year or net capital gain is less than 50 percent of the S corporation's taxable income or the sales occur more than three years after the S election becomes effective. See Rev. Rul. 65-292, 1965-1 C.B. 319.

3. Small Closely Held Corporations

The special grandfather provision for small, closely held companies making distributions before Jan. 1, 1989 applies to nonliquidating distributions as well. See H. Con. Res. 395 (75). Accordingly, eligible corporations may make nonrecognition distributions with respect to qualified stock until January 1, 1989. If nonqualifying stock is redeemed by the corporation leaving only qualifying stock outstanding, all nonliquidating distributions by such corporation prior to January 1, 1989 may be subject to nonrecognition (other than distributions of ordinary income or short term capital gain property).

D. Planning Strategies: After the New Provisions Are Effective

1. Tax-free Acquisitions

a. Reorganizations

Acquisitions structured as tax-free reorganizations offer an opportunity for current gain nonrecognition. However, the transferee of assets in such transactions generally must take a carryover, instead of a stepped-up, basis.

b. Corporate joint ventures

Example: X owns all of the stock of T. P would like to acquire an interest in T. No current tax would result if T and P together create Newco, whereby T
contributes its assets and P contributes other assets, or cash. The result will be that and T and P own stock in Newco in a proportion depending on the amount of cash or other assets contributed by P. No current tax on the transaction is recognized to any party. If P contributes cash or assets to Newco sufficient to give P an 80-percent interest in Newco, P and Newco may file a consolidated return so that the current operations of T's business are taxed only once.

A variation on this fact pattern is the contribution of the stock of T by X to Newco. The result will be that T becomes a wholly owned subsidiary of Newco, and P and X own stock in Newco in a proportion depending on the amount of cash or other assets contributed by P.

The principal drawbacks of this structure are that the assets of T do not enjoy a step-up in basis and no cash is conveyed to T's shareholder.

c. Joint ventures and partnerships

P would like to acquire an interest in T. No current tax would result if T and P together create a joint venture or partnership, whereby T contributes its assets and P contributes cash or other assets. The respective contributions are tax-free under § 721. Subsequent operations would not be taxed at the partnership/joint venture level.

2. Taxable Acquisitions

a. Election under § 338(h)(10)

Generally speaking, in any taxable stock purchase (barring any unusual circumstances with respect to inside and outside basis, tax attributes of the target corporation and the tax situation of the buyer), whenever the requirements for making a § 338(h)(10) election can be met, the election should be made.
b. **Mirror Transaction: No Corporate Tax**

P intends to acquire T. T is a holding company that owns all of the stock of four subsidiaries, T-1, T-2, T-3, and T-4. P will use some of its own funds and will borrow additional funds. P forms four first-tier subsidiaries, P-1, P-2, P-3, and P-4. Each subsidiary is capitalized to reflect the fair market value of the corresponding T subsidiary. Collectively, P-1, P-2, P-3 and P-4 then form P-5 and together contribute the funds received from P to P-5. P-5 then merges into T with T surviving. The merger constitutes a qualified stock purchase by P to the extent of P's funds, and a redemption by T to the extent of borrowings.

T is then liquidated in a liquidation to which § 332 applies. In the liquidation, the following stock is distributed: T-1 to P-1, T-2 to P-2, T-3 to P-3, and T-4 to P-4. P then may sell any unwanted P subsidiary without recognizing gain because, under § 358, P's basis in each subsidiary is equal to amount with which it was capitalized (an amount equal to the value of the corresponding T subsidiary's assets). No corporate level gain is recognized because the entire transaction involves only stock transfers.

Note: A critical element of the mirror transaction is the tax-free liquidation of T pursuant to the exception for § 332 liquidations. This will depend upon the P subsidiaries being viewed collectively as the 80-percent distributee. However, a footnote to the legislative history in the Conference Report suggests that Treasury should provide rules for this situation. Conf. Rep. 841, supra, at II-202 n.9. Such rules may be written to prevent the P subsidiaries from qualifying together as the 80-percent distributee.

3. **Corporate Divisions**

Distributions pursuant to § 355 do not appear to be subject to corporate level gain recognition under new § 311(b). Accordingly, corporations would be well advised to divide up their various
businesses into separate corporations, and distribute the stock tax-free under § 355. This will facilitate subsequent reorganizations, liquidations or sales of particular businesses, obviating the need to take certain assets out of corporate solution in such instances in order to separate lines of business at that time. Reorganizations and liquidations may follow immediately upon a § 355 distribution. If, however, the distributee of stock in the new subsidiary sells such stock too soon after receiving it, the distribution may be treated as an impermissible device and therefore not qualify for shareholder level nonrecognition under § 355.

4. New Businesses

New businesses should avoid C corporation form; instead, they should utilize joint ventures, partnerships or S corporations.

5. Conversion from C Corporation to S Corporation Status

Upon converting from C corporation to S corporation status after December 31, 1986, corporations should document any "built-in gain" in the company's assets in order to obviate problems of proof in connection with dispositions of such assets during the following 10 years.

6. Use of Master Limited Partnerships

Master limited partnerships ("MLPs") enjoy the tax advantages of partnerships (e.g., no double taxation of income) and yet offer partnership units as readily tradable as corporate stock. Following the repeal of the General Utilities rule and the increased tax rates imposed on corporate income, MLPs offer an attractive alternative to the C corporation form.

a. Structure

Typically, an MLP is formed by the contribution of assets by a so-called sponsor corporation to a partnership. The sponsor corporation retains control of business operations through a 1 percent general partnership interest. The sponsor may or may not purchase all or a portion of the limited partnership interests. Those
interests not purchased may be sold to the public to provide a source of equity capital for the MLP. Any MLP interests acquired by the sponsor may be sold to the public, retained, or distributed to shareholders.

b. **Tax consequences**

No gain or loss is recognized to the sponsor or the purchasers of MLP units upon the contribution of property on the formation of the MLP. § 721. The partners obtain a substituted basis (outside basis) for their MLP interests. § 722. The MLP takes a carryover basis (inside basis) for any contributed assets. § 723.

A § 754 election may result in an inside basis step-up, under § 743(b) for sales of MLP interests and under § 734(b) for disbursements of MLP property to partners. The inside basis adjustment under § 743(b) is based on the difference between the seller's share of inside basis and the purchaser's acquisition cost. § 755. The inside basis adjustment under § 734(b) is based on any gain or loss recognized by the distributee partner. Id.

MLP partners realize gain on the sale or exchange of their MLP interests. § 741. An important risk to the success of the MLP is the constructive termination rule of § 708(b) which provides for termination of a partnership if 50 percent or more of the total interests in capital or profits are sold or exchanged within a 12-month period. In that event, the assets of the terminated partnership are deemed to be constructively distributed to the partners and then recontributed by them to a reconstructed partnership, with potentially adverse tax consequences.
A. Alternative minimum tax. In lieu of the add-on minimum tax presently applied to corporations, an alternative minimum tax is imposed at a lower rate than the regular tax, but on a broader income base. Act. § 701. (The abbreviation "alt. min." is used for alternative minimum.)

1. Amount. The alt. min. tax is equal to the excess of (a) the "tentative minimum tax" over (b) the "regular tax." Code section 55(a).

   a. Tentative minimum tax. The tentative minimum tax is equal to 20 percent of the excess of alt. min. taxable income over the exemption amount, less the alt. min. tax foreign tax credit. Code section 55(b)(1).

      i. Alt. min. taxable income is the corporation's taxable income, as adjusted pursuant to Code section 56 and Code section 58, in the case of a non-corporate taxpayer), increased by specified tax preferences. See B, C and D below.

      ii. The exemption amount for corporations is $40,000, reduced by 25 percent of the excess of alt. min. taxable income over $150,000, i.e., zero, where alt. min. taxable income is $310,000 or more. Code section 55(d)(2) and (3).

   b. Regular tax. Regular tax is the regular tax liability of the corporation, as defined by Code section 26(b) (as amended by the 1984 Act), with the following adjustments, Code section 55(c): 

      i. It is reduced by the foreign tax credit allowed under Code section 27(a); and 

      ii. The tax on lump sum distributions under Code section 402(e) and recaptured tax credit under Code section 47 are expressly excluded.

   c. Alt. min. tax foreign tax credit. The alt. min. tax foreign tax credit is specially calculated and limited under Code section 59(a).
i. It is calculated as follows, Code section 59(a)(1):

(a) as if the tentative minimum tax were the tax against which the Code section 904 credit is taken, for years after 1986;

(b) as if Code section 904 were applied on the basis of alt. min. taxable income; and

(c) as if, for purposes of Code section 904, any increase in alt. min. taxable income from the adjustment for book income has the same proportionate source and character as the alt. min. taxable income without regard to such increase.

ii. It is limited to the excess, if any, of the tentative minimum tax over 10% of the tentative minimum tax with regard to the alternative net operating loss deduction, with any unusable portion being treated as a carryover or carryback under section 904(c). Code section 59(a)(2).

iii. The Conference Report indicates that rules similar to those applied upon the enactment of the individual alt. min. tax in 1982 are to be used for carryforwards from, and carrybacks to, pre-1987 years. H. Rep. 99-481, at II-282.

2. Tax credits. Tax credits generally may not be offset against the portion of income tax liability equal to the tentative minimum tax.

a. Limitations. Specific limits are added to the various credits which remain available under the new law.

i. General business credit. Code section 38(1) and (2) (lesser of (a) $25,000 plus 75% of regular tax liability over that amount; or (b) excess of regular tax liability over tentative minimum tax).
ii. Credit for clinical testing expenses. Code section 28(d)(2) (same as (b) in i).

iii. Credit for production of fuel from nonconventional sources. Code section 29(b)(5) (same as (b) in i).

b. Transitional rule. A special rule is provided for C corporations, which allows them to offset available general business credits against 25 percent of the tentative minimum tax, if that allows a greater amount of credits to be used, provided that the alt. min. tax is not less than 10 percent of the tentative minimum tax (combined with the effect of the alternative net operating loss ("NOL) deduction and the alt. min. tax foreign tax credit.)

3. Special rules.

a. Certain passthrough entities. Any items of tax preference or other items treated differently under the alt. min. tax rules are to be apportioned pursuant to regulations, as follows:

i. Between regulated investment companies and real estate investment trusts and their equity owners. Code section 59(d)(1)(A); and

ii. Pro rata among the participants of a common trust fund, as defined in Code section 584. Code section 59(d)(1)(B).

b. Section 936. Income of a Code section 936 possessions corporation eligible for the credit under that section is not subject to the alt. min. tax. Code section 59(b).

4. Estimated tax payments. Corporations will be required to include the alt. min. tax in their estimated tax payments. Code section 6154(c)(1). Corresponding changes are made in the credit and penalty provisions relating to estimated tax payments. Code sections 6425(c)(1), 6655(f)(1).
B. Alt. min. taxable income.

1. General. Alt. min. taxable income of a corporation is equal to its taxable income, increased by the preferences in Code section 57, and adjusted as provided in Code section 56.

   a. Code section 291. Except as otherwise provided, Code section 291 is to be applied before the application of the alt. min. tax provisions. Code section 59(f).

   b. Tax benefit rule. Treasury is authorized, but not required, to issue regulations providing for appropriate adjustments where an item treated differently for alt. min. tax purposes does not reduce the regular tax for any taxable year, e.g., by reason of the tax benefit rule. Code section 59(g).

   c. Limitations. The basis limitations of Code sections 704(d) and 1366(d) and the at risk limits of Code section 465 are to be applied in computing alt. min. taxable income, as follows, Code section 59(h):

      i. With the adjustments of Code section 56, as discussed below; and

      ii. Not taking into account any deduction to the extent it is a tax preference under Code section 57.

2. Preferences. The following are the tax preference items under Code section 57 applicable to a corporation (with a parenthetical indication whether it is the same as present law, modified, or new).

   a. Depletion (same as present law). The excess of the allowable deduction for depletion for each property in each year over the adjusted basis of such property at the end of the year (without regard to such deduction) is a preference item. Code section 57(a)(1). See old Code section 57(a)(8).

   b. Intangible drilling costs (modified and expanded). Previously only for personal holding companies, now for all corporations, the amount by which the excess intangible drilling costs
exceed 65 percent (formerly 100 percent) of the net income from oil, gas and geothermal properties. Code section 57(a)(2).

i. Excess intangible drilling costs are defined as under present law. Code section 57(a)(2)(B) and (C). See old Code section 57(a)(11)(B) and (C). They are the excess of the allowable costs over the amount which would have been allowable using a straight line recovery of intangibles, also defined as under old law. Code section 57(b). See old Code section 57(d). The preference is calculated separately for geothermal properties as under old law. Code section 57(a)(2)(1). See old Code section 57(a)(11)(D).

ii. A 10-year writeoff election is available to avoid the treatment of any portion of the costs as a tax preference item. See 59(e). This is modified slightly from present law and is discussed below.

c. Financial institution bad debt reserves (same as present law). The excess of the allowable bad debt reserve deduction over the amount that would have been allowable based on actual experience is a preference. Code section 57(a)(4). See old Code section 57(a)(7). This preference item will no longer be available to "large banks," as defined in new Code section 585(c).

d. Certain tax exempt interest (new). Interest on specified "private activity bonds," reduced by any disallowed deduction allocable to such bonds, will be a preference item. Code section 57(a)(5)(A).

i. Pursuant to regulations, exempt interest dividends, as defined in Code section 852(b)(5)(A), will be similarly treated, proportionately to the interest received by the distributing company on such bonds.

ii. Specified private activity bonds include any such bond, as defined in Code section 141, issued after August 7, 1986, except the following:
(a) Qualified Code section 501(c)(3) bonds, as defined in Code section 145; and

(b) Refunding bonds issued to refund pre-August 8, 1986 bonds.

iii. Bonds issued before September 1, 1986 will be deemed to have been issued before August 8, 1986 if they are covered by the "Joint Statement on Effective Dates of March 14, 1986," which generally guaranteed non-preference treatment for governmental bonds (under present law, with an expanded security test) issued before September 1, 1986. Section 57(a)(5)(C). H. Rep. 99-841, at H-269.

iv. "For purposes of this subtitle, interest shall not fail to be treated as wholly exempt from tax by reason of being included in alternative minimum taxable income." Code section 59(i).

e. Charitable contribution of appreciated property (new). The amount of untaxed appreciation on property donated to a charity which generates a deduction under Code section 170 is a preference. Code section 57(a)(6). If the taxpayer elects to reduce the deduction under Code section 170(e)(1), there will not be a preference. Under the transitional rules, carryovers from contributions made before August 16, 1986 will not be a preference item. Act, §701(f)(4).

f. Pre-1987 asset depreciation (same as present law). Depreciation on property placed in service before 1986 (unless an election is made to have the new law apply, for property placed in service after June 30, 1986) and property eligible under the transition rules of the Art. § 203 continues to be a preference item only to the extent it is such under present law. Code section 57(a)(7). This includes the following portions of old Code section 57:

i. Accelerated depreciation on Code section 1250 property -- all corporations. Old Code section 57(a)(2) and (12)(B).
ii. Accelerated depreciation on leased Code section 1245 property - personal holding companies only. Old Code section 57(a)(3) and (12)(A).

iii. Amortization of pollution control facilities - all corporations. Old Code section 57(a)(4).

3. Adjustments. The following adjustments are made pursuant to Code section 57(a) by all taxpayers, in calculating alt. min. taxable income.

a. Depreciation. The alternative depreciation system of Code section 168(g) is used for Code section 1250 property and property with respect to which straight line depreciation is used. Code section 56(a)(1)(A). The 150 percent declining balance method is used for all other property depreciated under new Code section 168. Thus, such method is not used for transitional rule property, pre-1987 property and property depreciated on a unit of production method, film and video tape, sound recordings, and public utility property not subject to Code section 168. Code section 56(a)(1)(B) and (C).

b. Mining exploration and development costs. This is similar to the preference under present law, which applied to personal holding companies only, providing that the excess of (a) the amount of development control mining exploration costs deductible under Code sections 616(a) and 617(a) over (b) such amount if amortized over 10 years is a preference item. Instead, such costs are amortized over 10 years by all corporations for purposes of calculating alt. min. taxable income. Code section 56(a)(2).

i. The amount to be amortized is determined without regard to Code section 291.

ii. If a loss is sustained on a disposition of the property, a deduction is allowed equal to the lesser of the unamortized costs or the loss that would have been allowed for the capitalized expenditures.
iii. The taxpayer may elect a 10-year writeoff, discussed below.

c. Long term contracts. This is new, requiring the use of the percentage of completion method for long-term contracts entered into on or after March 1, 1986, irrespective of the method used for regular tax purposes. Code section 56(a)(3).

d. Alternative net operating loss. A modified alternative net operating loss ("NOL") deduction, as defined in section 56(d), is used in lieu of the Code section 172 net operating loss deduction. Code section 56(a)(4).

i. The amount of the alternative NOL deduction may not exceed 90 percent of alt. min. taxable income. Disallowed amounts may be carried back and forward, but carrybacks and carryovers are subject to the same limitations. Code section 56(d)(1)(B)(ii). An election to relinquish carrybacks for regular tax purposes also applies for alt. min. tax purposes.

ii. The NOL deduction is to be adjusted as follows:

(a) For post-1986 loss years, it is to be calculated with the adjustments provided by Code section 56 and increased by the preferences in Code section 57 (other than for charitable contributions of appreciated property).

(b) For pre-1987 years, the amount of the carryovers is limited to that carried to the first taxable year after 1986.

iii. The Conference Report in this context notes "the parallel nature of the regular and minimum tax system." Query Section 382 limitations?

e. Pollution control facilities. This is similar to present law and provides that the amortization deduction for pollution control facilities under Code section 169 will be
calculated using the Code section 168(g)
alternative method of depreciation. Code section
56(a)(5). The amount to be amortized is deter-
mined without regard to Code section 291.

f. **Installment sales.** This is new and provides
that all income from sales of inventory after
March 1, 1986 and from the disposition of
property described in new Code section 453C(e)(1)
will be included without regard to the
installment method of reporting. Code section
56(a)(6). Property described in Code section
453C(e)(1) includes real and personal property
sold in the ordinary course of business and real
property held for rent with a price in excess of
$150,000. A taxpayer may elect to exclude from
Code section 453C(e) time share units and
unimproved residential lots.

g. **Adjusted basis.** The adjusted basis of
property subject to the foregoing rules is to be
determined on the basis of such rules. Code
section 56(a)(7).

h. **10-year writeoff election.** As under present
law, a taxpayer can elect to deduct "qualified
expenditures" over a 10-year or 3-year period and
effectively avoid their being subject to the alt.
min. tax. Code section 59(e). In contrast to
present law, this election can be made with
respect to any portion of such expenditures.
Code section 59(e)(4)(A).

i. The qualified expenditures relevant to
a corporation are those for intangible
drilling and development expenditures,
development costs and mining exploration
costs. Code section 59(e)(2)(C)(D) and (E).

ii. As under present law, such deductions
are to be recaptured upon a disposition of
the relevant property. Code section
59(e)(5).

4. **Corporate adjustments.** The following adjustments
are made only by corporations in calculating alt. min.
taxable income.
a. Book income/Current Earnings. These two adjustments are discussed in much detail below.

i. For taxable years beginning in 1987, 1988 or 1989, alt. min. taxable income is to be increased by 50 percent of the excess of "adjusted book income" over alt. min. taxable income (determined without regard to this adjustment or the alternative NOL deduction). Code section 57(c)(1)(A).

ii. For taxable years beginning after 1989, alt. min. taxable income is to be adjusted upward or downward with reference to "adjusted current earnings," which corresponds roughly to the current earnings and profits of the corporation. Code section 56(c)(1)(B).

iii. This adjustment does not apply to passthrough entities (S corporations, regulated investment companies, real estate investment trusts and REMICs. Code section 56(f)(4) and (g)(6).

iv. Treasury is to conduct a study of the book income and earnings and profits provisions. Act, § 702.


c. Blue Cross/Blue Shield. The deduction provided under section 833(b) to Blue Cross and Blue Shield organizations is disallowed. Code section 56(c)(3).

C. Adjusted book income.

1. Amount of adjustment. For taxable years beginning in 1987, 1988 and 1989, a corporation's alt. min. taxable income is increased by 50 percent of the amount by which its adjusted net book income exceeds its alt. min. taxable income (determined without regard to such adjustment or the alternative NOL deduction). Code section 56(f)(1).
2. **Adjusted net book income.** This is the net income or loss shown on the corporation's "applicable financial statement," with specified adjustments described below. Code section 56(f)(2)(A).

   a. **Applicable financial statement.** The Code provides a list of financial statements and indicates that the applicable financial statement, where a corporation has more than one on the following list, is to be the highest on such list (specified as the lowest numbered clause or subclause in Code section 56(f)(3)(A)):

      i. Any statements filed with the SEC.

      ii. Certified audited income statement used for a statement or report to shareholders.

      iii. Certified audited income statement used for a statement or report to creditors.

      iv. Certified audited income statement used for "any other substantial nontax purpose," e.g., a regulatory filing with a utility commission or other supervisory agency.

      v. Any income statement provided to the federal government or any agency thereof.

      vi. Any income statement provided to a state or any agency thereof.

      vii. Any income statement provided to a political subdivision of a state or any agency thereof.

      viii. Any income statement used for purposes of a statement or report for credit purposes.

      ix. Any income statement used for purposes of a statement or report to shareholders.
x. Any income statement used for purposes of a statement or report for "any other substantial nontax purpose."

b. Earnings and profits. A taxpayer without any of the foregoing is to use its pre-distribution earnings and profits as its net income or loss. Code section 56(f)(3)(B)(i). In addition, a taxpayer having only an unaudited income statement used for credit purposes, report to shareholders, or some other nontax purposes (items viii, ix and x above) may elect to use its earnings and profits.

i. Such election is revocable only with the consent of the Service and is made with respect to each year.

ii. The adjustments to be made (set forth below) to net income or loss shown on an applicable financial statement are to be made equally to net income based on earnings and profits. H. Rep. 99-841, at II-224.

iii. The calculation of earnings and profits is to be made without regard to the rules for "adjusted current earnings," discussed below. Id.

3. Adjustments. A number of adjustments to net income or loss are to be made, most of which apply generally, but some of which apply only to certain types of corporations.

a. Federal/foreign taxes. All federal income taxes and all foreign income, war profits and excess profits taxes directly or indirectly reflected in net income or loss are to be disregarded, except to the extent the taxpayer does not take the foreign tax credit, in the latter case. Code section 56(f)(2)(B).

i. The Conference Report indicates that adjustments in deferred taxes to reflect lower rates are to be disregarded. H. Rep. 99-841, as II-273.

ii. Excise taxes, including employment taxes paid by the Corporation, presumably are to be considered.
b. Duplication/omission. Treasury is to provide regulations providing for proper adjustments "to prevent the omission or duplication of any item." Code section 56(f)(2)(H).

i. The Conference Report indicates that these may include adjustments made "under the principles of Section 482." H. Rep. 99-841, at II-273, II-274.

ii. The Report also suggests that adjustments be made where disclosure in footnotes or other supplemental statements may be used to avoid the book preference. Id.

c. Different periods. Appropriate adjustments are to be made where the fiscal period of the applicable financial statement differs from that for the tax return. Code section 56(f)(2)(D).

d. Affiliated corporations. Two rules are provided with respect to affiliated corporations, presumably leaving for the regulations described above the resolution of other issues arising from the book, but not tax, consolidation of subsidiaries. Code section 56(f)(2)(C).

i. Earnings of subsidiary and affiliated corporations not filing consolidated returns are to be included is income only to the extent of actual dividends and other amounts included in gross income under the Code attributable to such earnings. Code section 56(f)(2)(C)(ii).

ii. The adjusted net book income of a taxpayer filing a consolidated return is to "take into account items on the taxpayer's applicable financial statement which are properly allocable to members of such group included on such return." Code section 56(f)(2)(C)(i). The Conference report indicates that the book incomes of such corporations are to be consolidated. H. Rep. 99-841, at II-274.

e. Cooperatives. Subchapter T cooperatives are allowed to reduce adjusted net book income by the amount of Code section 1382(b) patronage dividends and per unit retain allocations not
otherwise taken into account in determining such income. Code section 56(f)(2)(E).

i. Non-subchapter T cooperatives, e.g., taxable electric cooperatives, presumably do not get the benefit of this rule.

ii. Query if non-member patronage income is included.

f. Section 936 Corporations Dividends. A dividend received from a Section 936 corporation is to be increased by the amount of any withholding tax paid to the applicable U.S. possession with respect to such dividend. Code Section 56(f)(2)(F).

i. 50 percent of any withholding tax paid with respect to such dividends (up to the excess of adjusted net book income over alt. min. taxable income) is to be treated as paid by the corporation receiving the dividend for alt. min. tax purposes.

ii. Taxes paid by the section 936 corporation are to be treated as a withholding tax to the extent they would be a deemed paid tax under the rules of Code section 902.

g. Alaska native corporations. Two special rules are provided for Alaska native corporations. Code section 56(f)(2)(G).

i. Asset basis is to be that determined under the Alaska Native Claims Settlement Act, § 43 U.S.C. 1620(c).

ii. Amounts paid to other such corporations are to be deducted for minimum tax purposes only when deductible for regular taxes.

h. Insurance companies. The Conference Report indicates that the pre-tax book income of an insurance company whose applicable financial statement is the one filed for regulatory purposes is the amount of net gain from operations after dividends to policyholders and before Federal income taxes. H. Rep. 99-841, at II-273.
D. Adjusted current earnings.

1. Increase/decrease in alt. min. taxable income.
For years beginning after 1989, alt. min. taxable income is to be increased or decreased as follows:

a. Income. It is to be increased by 75 percent of the excess, if any, of adjusted current earnings over alt. min. taxable income (without regard to this adjustment or the alternative NOL deduction). Code section 56(g)(1). It is to be decreased by 75 percent of the excess, if any, of the latter amount over the former amount. Code section 56(g)(2)(A).

i. The decrease may not exceed the excess, if any, of the aggregate increases for all prior years over the aggregate decreases. Code section 56(g)(2)(B).

ii. A positive amount is in excess of a negative amount, and a smaller negative amount is in excess of larger negative amount. H. Rep. 99-841, at II-274.

iii. The availability of a decrease to a group filing consolidated returns is to be determined at the consolidated return level. H. Rep. 99-841, at II-278.

b. Adjusted current earnings. Adjusted current earnings is equal to alt. min. taxable with specified adjustments (in addition to those made in calculating alt. min. taxable income), without regard to the increase or decrease described above or the alternative NOL deduction. Code section 56(g)(3). This outline groups those adjustments into the following three categories: (1) depreciation, amortization and depletion adjustments; (2) E and P adjustments; and (3) policy adjustments.

2. Depreciation, amortization and depletion adjustments. All of these adjustments generally reduce the level of these types of deductions to the "lowest and slowest" available method.
a. Depreciation. The method of depreciation to be used depends on when property is or was placed in service and what method is used for regular tax purposes. Code section 56(g)(4)(A).

i. In the case of property placed in service in a taxable year beginning after 1989, depreciation is to be determined using either the book method or the Code section 168(g) alternative method, whichever yields the lower present value. Code section 56(g)(4)(A)(i).

(a) Present value is to be determined with respect to remaining deductions as of the date the property is placed in service or, if later, the beginning of the first taxable year after 1989, under regulations to be prescribed by Treasury. Code section 56(g)(5)(B).

(b) The discount rate is to be prescribed in such regulations. Until this is done, the applicable federal rates under Code section 1274 are to be used, based on the ADR midpoint life of the property. H. Rep. 99-841, at II-276.

ii. In the case of property placed in service in taxable years beginning before 1990, depreciation is to be determined using the method used for book purposes, if it has a lower present value (determined as described above, as of the beginning of the first taxable years after 1989) than the following methods, or such methods, if it does not.

(a) Property placed in service after 1980 - straight line method over the balance of the ADR midpoint life using the adjusted basis as of the beginning of the first taxable year after 1989 for regular tax purposes, in the case of pre-1987 ACRS property, and for minimum tax purposes, in the case of post-1986 ACRS property.
(b) Property placed in service before 1981 - the method used for regular tax purposes.

b. Intangible drilling costs and mineral exploration and development costs.

i. Those items are to be amortized using whichever of the following methods yields the lower present value (determined as set forth above): (1) amortization over 60 months and 120 months, respectively, as provided in Section 312(a); or (2) the method used for book purposes. Code section 56(g)(4)(D)(ii).

ii. Where a unit production method of amortization is used, regulations are to be provided to indicate "reasonable estimates" of the rates at which such costs are to be recovered for final accounting purposes. H. Rep. 99-841, at II-277. Similar rules are to be applied to mining and exploration costs.

c. Depletion. Depletion is to be calculated using whichever of the following methods yield the smaller present value (determined as provided above): (1) cost depletion determined under Code section 611; or (2) the method used for book purposes. Code section 56(g)(4)(G).

d. Acquisition expenses of life insurance companies. These expenses are to be capitalized and amortized under generally accepted accounting principles. Code section 56(g)(4)(F).

i. This calculation is done as if such principles applied for all years.

ii. Casualty and property insurance companies acquisition expenses are adjusted by a specified reduction in the unearned premium reserve deduction.

iii. The Conference Report indicates that the small life insurance company deduction under Section 806 and the small property and
casualty insurance company deduction under Section 831(6) do not apply. H. Rep. 99-841, at II-277.

e. Section 382. Where there has been an "ownership change," for purposes of Code section 382, after the date of enactment of the 1984 Act, if the Code section 382 stock value (properly adjusted for liabilities and other items) is less than the aggregate adjusted bases of the corporation's assets, then basis is to be adjusted downward (proportionately among the assets based on fair market value) to such value, for purposes of calculating current adjusted earnings. Code section 56(g)(4)(H).

3. E & P adjustments. A number of adjustments more closely align current earnings with the earnings and profits of the corporation.

a. Gross income exclusions. Items that are excluded from gross income but included in earnings and profits are included in current earnings. Code section 56(g)(4)(B)(i).

i. Otherwise non-deductible items are allowed as deductions to the extent allocable to such excluded items. Code section 56(g)(4)(B)(i)(II).

ii. The original discount and market discount rules are to be applied in calculating income from exempt bonds. H. Rep. 99-841, at II-274.

iii. Again, Code section 59(i): "interest shall not fail to be treated as wholly exempt ... by reason of being included in alternative minimum taxable income."

b. Excluded deductions. Deductions allowed for regular tax purposes which are disregarded for earnings and profits purposes are disregarded, with two exceptions. Code section 56(g)(4)(c).

i. The 80-percent dividends received deductions under Code section 243 is always disregarded, but the 100 percent deduction under Code section 243 or 245 is not disregarded if it is paid by a corporation
which could not be in the same affiliated group as the recipient by reason of Code section 1504(b), provided that the dividend is attributable to income which is subject to tax.

ii. Dividends from section 936 corporations may generate deemed paid foreign tax credits in the same manner as for the book income adjustment, except that 75 percent is used instead of 50 percent.

c. Code section 312(n). The adjustments to earnings and profits added by the Tax Reform Act of 1984 generally are applicable, with appropriate transition rules, except for the adjustment for redemptions and the special rule for foreign corporations. Code section 56(g)(4)(D)(i).

i. The "avoided cost" method of Code section 263A is to be used to calculate the amount of interest allocable to production, whether or not required, authorized or considered appropriate under financial or regulatory accounting principles applicable to the taxpayer. H. Rep. 99-841, at II-278.

ii. The Conference Report indicates that Treasury is to provide regulations to avoid duplications and omissions in groups filing consolidated returns. H. Rep. 99-841, at II-278.

4. Policy adjustments. These adjustments seem based more on policy concerns extrinsic to earnings and profits.

a. Inside buildup. The inside buildup in appreciation of life insurance policies and annuity contracts is to be included in adjusted current earnings. Code section 56(g)(4)(B)(ii) and (iii). The portion of any premium allocable to insurance coverage is to be deductible.
b. Debt pool exchange. No loss is to be recognized on the exchange of pools of debt obligations having substantially the same interest rate and maturities. Code section 56(g)(4)(E).

5. Records. The Conference Report indicates an intent for the adjusted earnings and profits and general minimum tax systems to be "integrated regarded record keeping to the maximum extent feasible." H. Rep. 99-841, at II-278. Treasury is to provide guidance in regulations and rulings by the end of 1989 and to consider this issue in its study of book income.

E. Minimum tax credit.

1. Purpose. This credit is intended to alleviate timing differences that arise under the minimum tax system, principally in the book income and current earnings areas.

2. Amount. The minimum tax credit is equal to the excess, if any, of the cumulative "adjusted net minimum tax" for prior years over the previously allowed credit, subject to the following limitations. Code section 53(a) and (b).

   a. Limitations. The credit for any year may not exceed the excess of the regular tax liability (net of other tax credits) over the tentative minimum tax for the year. Code section 53(c).

   b. Adjusted Net Minimum Tax. This is equal to the alt. min. tax, reduced by the portion of such tax attributable to depletion, tax exempt interest, charitable contributions of appreciated property and the Code section 833(b) deduction. Code section 53(d).

F. Effective dates.


2. Special. Special rules are provided for three elements of the alt. min. tax.
a. **Alternative NOL deduction.** Carryovers of pre-1987 NOL's are to be reduced by the preferences attributed to deferred minimum tax. Act, § 701(f)(2)(B).

b. **Installment sales.** The adjustment under Code section 56(a)(6) is not to be made where Section 453C does not apply. Act, § 701(f)(3).

c. **Charitable contributions.** No preference under Code section 57(a)(6) will arise with respect to contributions before August 16, 1986. Act § 701(f)(4).

3. **Taxpayer specific rules.** Several transitional rules for specific taxpayers are provided.
1. Net operating losses (and other tax attribute carryovers) are designed to level the ups and downs of the annual tax accounting system. A corporation that earns $50 in each of two years should pay the same tax as a corporation that loses $100 in year 1 and earns $200 in year 2. This rather simple fairness principle can quickly develop some thorny and difficult application problems.

1.1 Code §172 provides for NOL carry backs and carry forwards.

1.2 Code §381 permits NOL carryovers from the old loss corporation ("L") to a profitable purchasing or acquiring corporation ("P") in described tax-free acquisitions.

1.3 Old Code §382(a) [the 1954 Code, excluding the 1976 amendments to Code §382] killed NOL carryovers if L changed stockholders and changed its business.

1.4 Old Code §382(b) cut back NOL carryovers after certain tax free acquisitions of L by P if L's old shareholders

*Milgrim Thomajan Jacobs & Lee
Professional Corporation
New York, New York
maintained less than a 20% ownership in P. [That rule could, however, be avoided in triangular acquisitions.]

1.5 Code §269 disallowed NOLs if L's control (or assets) had been acquired by P for the principal purpose of tax avoidance.

2. The old rules did not work well.

2.1 Permitted P to offset its unrelated income with acquired L losses.

2.2 Reimbursement system (i.e., IRS would refund previously paid tax to L) rejected as inappropriate and inefficient corrective mechanism.

2.3 The Bill (H.R. 3838, "The Tax Reform Act of 1986") cuts down loss carryover utilization when there has been a majority change in stock ownership or a break in business continuity.

2.3.1 The Bill rejected the 1976 approach of terminating L's NOLs whenever there was a change in control, believing that it might unduly discourage worthwhile ownership changes.
2.3.2 Strict business continuity requirements would discourage rehabilitation of troubled businesses, but lesser continuity of business enterprise concepts in reorganization regulations found comfortable.

2.4 In short, old 1954 Code law found too harsh where L's shareholders continue and ineffective where shareholder changes have been effected; old law provided discontinuities between taxable and tax-free transfers and presented opportunities for tax avoidance.

3. Noble efforts to remedy these shortfalls.

3.1 The 1958 Advisory Group.

The 1958 Subchapter C Advisory Group\(^1\) recommended that following a change in L's control, loss carryovers be allowed only to the extent of 50% of the consideration paid by P for L, a rule that would effectively thwart a tax avoidance purchase of a shell loss corporation because the after-tax value of the allowed loss could never equal the purchase price. The Advisory Group proposal also prohibited "stuffing" L with cash

or investment assets to artificially augment the purchase price
and NOL measure.

3.2 ALI.

The 1982 American Law Institute study fashioned a
"neutrality principle" to serve as the centerpiece of its
proposal, permitting NOLs to carryover after a change of
controlling ownership only to the extent L would have generated
income sufficient to absorb them. The ALI proposal did not
limit the losses themselves, but rather the earnings available
for offset against the losses. The ALI's pool of capital
approach likened the new corporate enterprise to a partnership,
permitting the combined P-L entity to offset its earning stream
income by the amounts L would have generated (or was deemed to
have contributed) to the combined entity.

3.3 NYSBA.

The New York State Bar Association Tax Section
recommended a limitation similar to the 1958 Advisory Group's

2 American Law Institute, Federal Income Tax Project, Subchapter
(1982).
proposal for post-acquisition losses,\(^3\) limiting loss carryovers to 100\% of the acquisition price of the loss corporation and spreading the loss utilization over at least five years.

3.4 Bacon and Tomasulo.

In 1983, two former Joint Committee Staff members, Richard Bacon and Nicholas Tomasulo, published their proposed revision to Code §382,\(^4\) permitting NOL carryovers equal to the full acquisition price in both taxable and tax-free acquisitions. The purchase price limitation was triggered by a major control shift and was reduced by L's cash or liquid assets, by business assets contributed to the company within 2 years of the triggering event and by assets sales proceeds (other than in the ordinary course of business) within 5 years after the triggering event.

3.5 ABA.

In early 1985, the American Bar Association Tax Section completed its Code §382 study,\(^5\) issuing a legislative recom-

---


4 20 Tax Notes 385 (Sept. 12, 1983).

mendation utilizing a single purchase price formulation to effect the neutrality principle. The ABA concluded \( P \) should be able to use \( L \)'s NOLs to the same extent (on a present value basis) as \( L \) could use them. Under the ABA Draft, NOLs equal to 2% of the purchase price could be used each month for 60 months following a change in control. The ABA Draft provided no special treatment for investment companies because no profit could be derived from purchasing shell or investment companies for their tax losses. Old and cold (2 year) debt converted into equity by the seller or purchaser would be treated as part of the purchase price measure for NOL utilization. Anti-stuffing rules and built-in gains and losses receive special treatment. Finally section 269 was made inapplicable to transactions covered by new Code §382.

3.6 SFC Staff Green Book.

The Senate Finance Committee Staff's Green Book borrowed heavily (and well) from the earlier studies, embracing the neutrality principle and criticizing current law and the 1976 Act as not focusing on the ability (or inability) of the loss corporation to use its losses while frequently permitting

---

6 Staff of Senate Committee on Finance, 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985 (the "Green Book").
purely tax motivated transactions to be effected. The Green Book criticizes existing law as --

3.6.1 Giving too much weight to the continuity of business rules;

3.6.2 Providing an all or nothing cliff effect, in many cases unjustly preserving in tact or completely forfeiting NOLs;

3.6.3 Placing too much reliance on the 20 percent continuity of shareholder interest in reorganization transactions;

3.6.4 Failing to recognize the effect of built-in gains and losses on the operation of Code §§382 and 383; and

3.6.5 Being inconsistent, complex, uncertain and incomplete.

The Green Book proposed a single neutrality principled rule that would limit tax attribute carryover utilization to an assumed amount each year following a prescribed change in corporate ownership. That utilization rate was fixed as the product of the value of the loss corporation at the time of ownership change times the Federal long-term rate prescribed by
Code §1274(d). The Green Book provided a rigorous anti-stuffing rule to prevent an 'artificial augmentation of the purchase price; provided no carryovers for "investment companies" and provided for built-in gains and losses. Special considerations were granted insolvent corporations and corporations involved in title 11 proceedings. Code §269 and Libson Shops would not apply to transactions covered by GB §§382, 382A and 383.

4. Legislative Developments.


4.3 NOL carryover limits on list of Ways & Means "reform options" (September, 1985).

4.4 House Bill (H.R. 3838), §321, largely tracks original Green Book proposal.
4.5 SFC version of H.R. 3838, §621, adopts SFC Staff proposal (with minor modifications). A staff, rather than member driven process.

4.6 Semi-Final Solution. Exchange of offers between conferees.


4.8 Final bill language written by Joint Committee staff "alters the character of the special limitations on the use of NOL carry forwards in a manner generally similar to the House bill and Senate amendment." Conf. Rep. at II-172. Much of the details are quite new and far reaching.

5. New Code §382 [H.R. 3838, Title VI, Subtitle C. Sec. 621, Conf. Rep. ("CR") I-179] changes fundamentally those rules. Central Theme: Avoid ownership change and you avoid these new Code §382 limitations. If ownership changes, each subsequent year the allowed NOL will be limited to the "Section 382 Limitation," (i.e., the value of L equity (on the acquisition date) multiplied by the "long-term tax exempt rate." Code §382(b)(1). Any unused Section §382 Limitation is carried forward to the next year. Code §382(b)(2).
Example (1). P buys all the outstanding L stock from A for $1,000. The purchase by P constitutes an "owner shift and an ownership change." Assuming the long-term tax exempt rate is 6%, each taxable year following the ownership change, L may deduct $60 of L's otherwise available NOL carry forwards.

6. "Ownership changes" are bad! They trigger the Section 382 Limitation. An ownership change is effected by --

6.1 an owner shift. Code §382(g)(2). Involves 5% shareholders whose interest in L goes up or down, or

6.2 an equity structure shift. Code §382(g)(3). Involves tax-free and taxable reorganizations and reorganization-type transactions.

Generally, if percentage of L stock owned by 5% shareholders has increased by more than 50 percentage points in three year testing period, an NOL tax cognizable ownership change will have been effected. Because the new NOL Section 382 Limitation provisions operate only after an owner shift -- changes involving "five percent or greater shareholders" -- public companies that have no 5% shareholders (or who have no ownership changes involving 5% shareholders) should not be affected by the new limitations, even though their beneficial owners are.
substantially or completely changed through stock market purchases.

Example (2). L stock is publicly traded; no shareholder owns 5%. During 3 year testing period, all shares are traded; no one ever owns 5%. No owner shift.

7. Owner Shift -- any change in L stock ownership affecting 5% or greater shareholder. Code §382(g)(1). Includes --

7.1 Taxable purchase by 5% L shareholder (before of after purchase).

7.2 Sale by person owning 5% of L before or after sale.

7.3 A section 351 exchange, redemption, recapitalization or stock issuance by L that affects percentage of L stock owned 5% shareholders.

7.4 If L (or its shareholders) sell shares to 5% shareholders who purchase 50% or more of L -- owner shift.

7.5 L stock owned by all less than 5% L shareholders is aggregated and treated as owned by a single 5% shareholder.
CR II-175. Where two groups of less than 5% shareholders are (or can and should be) identified, the aggregated single 5% shareholder rule is applied separately to each group. Code §382(g)(4); CR II-180 (Ex.15).

8. Equity Structure Shift.

8.1 A tax-free or taxable reorganization or public offering or similar transaction. Code §382(g)(3). Exception for (D) and (G) reorganizations unless Code §354(b)(1) is satisfied.

8.2 Look only to changes among 5% shareholders (including aggregated less than 5% shareholders).

Example (3). L is merged into P Corporation with P surviving. Both L and P are publicly traded with no 5% shareholders. In the merger, L shareholders receive 30% of P stock. There has been an equity structure shift ownership change because the P stock owned by former P shareholders (treated as a separate 5% shareholder from L's former shareholders) has been increased from 0 to 70% of L. CR II-177.

Elaborate rules attribute ownership from corporations to shareholders without regard to the extent of the shareholders' ownership in the corporation. All stock owned by a corporation is treated as being owned proportionately by its shareholders and except as provided in regulations is not treated as being held by the corporation. Thus, when P acquires all the L stock, look to P's shareholders and L's shareholders to determine whether there has been an owner shift. P's existence is ignored. CR II-180 Ex. 15.

Example (4). P (no 5% shareholders) acquires (L) (no 5% shareholders). Do not look to P's acquisition of L. Rather look to L's beneficial owners after the acquisition. Disregard P. Code §318(a)(2) attribution [from corporations] is applied without the normal 50% threshold requirement of Code §318(a)(2)(C). Code §382(1)(3)(A) CR I-186, II-180. If P's former shareholders own more than 50% of P (which owns L) after the transaction, an ownership change has been effected and the Section 382 Limitations are operative.
Example (5). Suppose corporate raiders A, B and C acquire 10, 15 and 20 percent of L (the target corporation in Example 4) in NYSE transactions. Their purchases do not effect an owner shift because they have purchased less than 50% of L. Suppose C sells his 20% on the NYSE. D, one of the purchasers in C's sale, acquires 10% of L.

During the three year Code §382 measuring period, there has been an increase by 5% owners, A, B, C and D of 55%. Did D's purchases constitute an owner shift: ownership change triggering the Section 382 Limitation?

Owner shift --

(A) Change in ownership of L stock involving 5% shareholders.

(B) C's sale of his 10% L stock interest is a change that affects percentage of L ownership by C, whose ownership went from 20 to 0 and a change by D, whose ownership went from 0 to 10.

Code §382(g) defines an ownership change if immediately after any owner shift the percentage of L owned by one or more 5% shareholders has increased by more than 50 percentage points.
over lowest percentage owned during testing period. After the C - D owner shift:

<table>
<thead>
<tr>
<th></th>
<th>owns</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>B</td>
<td></td>
<td>15</td>
</tr>
<tr>
<td>C</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>D</td>
<td></td>
<td>10</td>
</tr>
</tbody>
</table>

35.

The A, C and D holdings of 35% of L are less than 50, so no ownership change has been effected and no Section 382 Limitation is applicable.

Example (6). L is publicly traded; no 5% shareholders; 1,000 shares outstanding. L issues 1,200 shares to new shareholders. No ownership change. Percentage of stock owned by less than 5% shareholders -- 100% before and 100% after stock offering. II-178. But, Regulations may change all this. Regulations could create two groups of less than 5% shareholders. Group I -- old L shareholders. Group II -- shareholders who bought in the public offering. Then - owner shift (or perhaps an equity structure shift under the public offering provision of Code §382(g)(3)(B)) and ownership change triggering Section 382 Limitation. If L's underwriter issued L stock on a
"firm commitment" basis, there would be an ownership change; the underwriter would be deemed a separate 5% owner. II-178 n. 7. But, if the underwriter issues the L stock on a "best efforts basis," the public issue is seemingly o.k. What if the underwriter agrees to both a best efforts public distribution and commits to "stand-by" to purchase any shares not purchased by the public. Seemingly o.k. too, unless the underwriter actually buys 5% or more. Watch for regulations to change this rule. The described offering of a majority of L stock to the public through an underwriter probably will be either an owner shift or not an owner shift, regardless of the type of underwriting used to effect the offering.

Example (7). A owns 10% of L. A sells 1% to each of 10 persons. This is an owner shift because there is a change involving A, a 5% shareholder. Code §382(g)(2) CR I-181; CR II-174. This owner shift may or may not effect an ownership change. Code §382(g)(1), in effect, directs us to take a snapshot after each owner shift to see if an ownership change has been effected.
Thus, if L, prior to A's sale was owned:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Public (less than 5% shareholders)</td>
<td>42</td>
<td></td>
</tr>
<tr>
<td></td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

If the public had purchased its stock from A, B and C (or L) within three years, A's sale to the 10 purchasers would constitute both an owner shift (a transaction involving a more than 5% shareholder) and an ownership change, triggering the Section 382 Limitations because the public’s (aggregated less than 5% shareholders) ownership of L has increased from 0 to 52% during the three year testing period.

10. More Trigger ("Ownership Change") Examples.

Example (8). A (an individual) owns all the L stock. In an initial public offering (IPO), L issues 60% of its stock to new investors, none of whom owns 5% of L. A's reduction in interest from 100% to to 40% and the Public's purchase increases
its interest from 0% to 60% is an owner shift effecting an ownership change. Old Code §382(a) analogue.

Had L been publicly traded and owned by a group of less than 5% shareholders, issuing 60% of the L shares to other less than 5% shareholders presumably would not have triggered an ownership change. See Example (6) supra.

Example (9). Assume L is owned by the public (less than 5% shareholders). L sells 5% of its stock to each of 12 investors. Public change from 100% to 40% effects an owner shift; so, too, does the new shareholders increase from zero to 60%. The 60% increase by the new 5% shareholders effects an ownership change.

Example (10). L merges into P, after which A, L's sole shareholder owns 40% of P. A's ownership drop is more than 50%; an equity structure change under Code §382(g)(3). [Would have been O.K. under '76 Act]. In the equity structure shift, P's shareholders increased their ownership of L from 0 to 60% thus effecting an ownership change under Code §382(g)(1).
Had A received more than 50% of P in the L-P merger, the L-P merger would not have been an equity structure change and no ownership change. Code §382(g)(1). If instead A owned 20% of P before the L-P merger, after the L-P merger A would own 52% of L (the new loss corporation) (40% as a result of the merger and 12% as a result of her prior P ownership). Thus, after the equity structure shift, the percentage of stock owned by the P shareholders (other than A) have increased from 0 to 48%, a less than 50 percentage point increase. No ownership changed.

**Example (11).** On January 1, 1987, P purchases 45% of L from A. On July 1, 1989, P₁ (unrelated to either A or P), in an unrelated transaction, purchases 10% of L from A (or L or less than 5% shareholders). The July 1, 1989 purchase by P₁ is an ownership shift triggering the Section 382 Limitations.

**Example (12).**
L merges into P; in exchange for 10% of P stock. O.K. under 1954 Code §382(b)(6). Now; equity structure change effecting an ownership shift and Section 382 Limitations.

Example (13). L acquires all of P's voting stock from B, after which B owns 75% of L. This is a (B) reorganization [not a trigger under 1954 Code §382] -- a reverse acquisition. B now owns more than 50% of L. An equity structure change has been effected, effecting an ownership shift and Section 382 Limitations.

Example (14). A owns all the stock of L; B owns all the stock of P. A and B each transfer all their L and P stock to Holding Inc. in exchange for Holding common stock. A gets 50 Holding Inc. shares; B gets 50 Holding Inc. shares.

The transfers are not an ownership change under Code §382(g)(1) because A maintains a 50% interest in L through A's ownership of Holding Inc. Not so were A to get 45 Holding Inc. shares and B 55 Holding Inc. shares. B's interest in L would have increased by more than 50 percentage points, an owner shift effecting an ownership change. (R II-174 (4).

Were A to receive 100% of the Holding Inc. common and B receive 100% of Holding Inc. straight preferred described in
Code §1504(a)(4), no "trigger." Stock described in Code §1504(a) (4) is excluded from the term "Stock." Code §382(k)(6). Therefore, B's percentage of stock in L is zero and not increased by 50 percentage points.

Example (15). Assume L is owned by two unrelated shareholders, A (60%) and B (40%). L redeems A's interest. This is an owner shift. CR II-174(5). A's interest goes down by 60%; B's interest up by 60%, effecting an ownership change. Watch family redemptions in closely held corporations if Code §318 does not block trigger of equity shift. See Code §382(l)(3) denying Code §318(a)(1) family attribution but treating all §318(a)(1) family members as one individual.

11. Pro rata distributions produce no owner shift; non-pro rata distributions may produce owner shifts.

12. Modified attribution rules, gifts, decedent transfers, transfers to spouses in matrimonial actions and certain options are excluded from owner shift determinations. CR II-182-183.

13. Section 382 Limitation. The Section 382 Limitation is generally the L equity value immediately before the ownership change multiplied by the long-term tax exempt rate (presumably
between 66% and 100% of the long-term Federal rate, presently 6 to 8%). Equity value includes straight preferred stock value. Code §382(e)(1).

14. Anti-stuffing provisions. Capital contributions made to artificially augment Section 382 Limitation will be disregarded.

14.1 Except as provided in regulations, capital contributions during two year period ending on ownership change date irrebuttably presumed tax avoidance and subtracted from L equity value.

14.2 Regulations should except:

14.2.1 Capital received on formation of L (other than built-in losses).

14.2.2 Capital contributions prior to first NOL year.

14.2.3 Capital contributions to continue basic operations, e.g. payroll.

14.2.4 Deduct non-business assets on hand and distributions to shareholders subsequent to otherwise excepted capital contributions.
15. Passive Corporations. If at least one-third of L's assets consist of non-business assets, the Section 382 Limitation is reduced by that excess (over attributed debt).

15.1 50% subsidiaries not treated as investment assets but "looked through."

15.2 RICs, REITs and real estate mortgage investment conduits excused from passive corporation rule.

16. Built-in Gains and Losses. Net unrealized built-in losses recognized within five years treated as pre-change losses.

16.1 Net unrealized built-in loss defined as excess of aggregate adjusted bases of L's assets over their fair market value.

16.2 De minimus 25% rule. If built-in loss does not exceed 25% of value of L's assets immediately before ownership change, disregard built-ins.

16.3 Built-in gains offset built-in losses. Not applicable unless 25% de minimis threshold exceeded.

16.4 More work for the appraiser.
17. Insolvencies. General Section 382 Limitations not applicable in Title 11 cases if L's "shareholders and creditors (determined immediately before the ownership change)" own 50% of L's stock after ownership change.

17.1 Stock-for-debt-exchange or other transaction must be bankruptcy court ordered or court approved.

17.2 Stock-for-debt-exception available only to old and cold creditors, i.e., debt held for at least 18 months before bankruptcy filing or debt that arose in ordinary course of L's business and at all times is held by creditor-beneficial owner.

17.3 If bankruptcy exception applies --

17.3.1 Excused cancellation of indebtedness income in stock-for-debt-exchange reduces pre-change losses and excess credits by one-half excused income. Note -- Reduction here in NOL, not Section 382 Limitation.

17.3.2 L's pre-change NOLs reduced by interest on debt converted to stock and paid or accrued during three years preceding taxable year of ownership change.

17.4 A second ownership change during two years after insolvency ownership change will eliminate NOL that arose before first ownership change.
17.5 Treasury directed to study informal workouts.

18. Thrift Institutions.

18.1 Modified bankruptcy exceptions for (G) reorganizations and new stock issuances.

18.2 In general, ailing thrifts fared better than most.


19.1 Code § 269, SRLY and CRCO rules continue. CRII-194. If Section 382 Limitations are applicable it is all but inconceivable that the principal purpose of acquiring control of L was to secure L's NOLs.

19.2 "Libson Shops doctrine will have no application to transactions subject to the [new Code § 382] provisions." CRII-194. But, L must satisfy continuity of business enterprise regulations for two years following ownership change. If L flunks continuity test, all NOL carryovers are lost for all post-ownership change years. Code §382(C). [A limited exception provided for built-in gains and Code §338 gain.]

19.3 Treasury Department directed to prescribe regulations "preventing the avoidance of the purposes of Code §382
through the use of, among other things, pass-through entities, e.g., partnerships with flip-flops and other special allocations.

19.3.1 Conferees expect regulations to limit tax benefits from partnership allocations to loss partners. "This grant of authority contemplates any rules that the Treasury Department considers appropriate to achieve this objective." CR II-194.


21. Effective dates.


21.2 Equity structure shifts pursuant to reorganization plans adopted on or after January 1, 1987.


22.1 Earliest testing date for L stock transfers is May 6, 1986 (the date of SFC action).

22.2 1954 Code version remains applicable to transactions not covered by these tests. CR II-196. Forever?
Scope

Title XVIII of the Tax Reform Act of 1986 (the "1986 Act") includes several hundred technical corrections to the Deficit Reduction Act of 1984 ("the DRA 1984") and other tax recent legislation. A large number of these technical corrections will affect corporations and stockholders. The outline which follows, however, is limited to those technical corrections with have their exclusive or primary impact on corporations and/or stockholders. The outline does not discuss the technical corrections relating specifically to S corporations, foreign corporations or special corporations, such as DISCs, FSCs, life insurance companies and foreign personal holding companies.

Background

The earliest published version of what became Title XVIII of the TRA 1986 appeared as the Technical Corrections Act of 1985 (H.R. 1800 and S. 814, 99th Cong. 1st Sess.). This bill was introduced in both the Senate and the House of

I. Dividends and Other Corporate Distributions

A. Dividend Received Deduction

1. Foreign Distributing Corporation. Act Section 1804(a) clarifies the relationship between Sections 245 and 246A.* It limits applicability of the dividend received deduction on dividends paid to domestic corporations on portfolio stock of foreign corporations to the product of (1) the percentage of the foreign corporation's income which is effectively connected

*References to "Act Sections" are to sections of the 1986 Act. References to "Sections" are to sections of the Internal Revenue Code of 1986 and generally refer to sections of the Internal Revenue Code of 1954, as amended to October 1986.
with the conduct of a United States trade or business and (2) the percentage of the cost of the stock of the distributing foreign corporation which is not debt financed.

2. **45-Day Holding Period.** Act Section 1804(b)(1) revises the 45-day minimum holding period for stock subject to the dividend received deduction, under Code Section 246(c). The new rule will apply the 45-day limitation to situations where the stockholder does not sell or otherwise dispose of the stock. The holding period requirement is not violated simply because a dividend is paid within 45 days after the stockholder bought the stock. Note: It continues to be unclear whether the "tacking" rules of Section 1223 apply here.

B. **Stock Redemptions**

1. **Accumulated Earnings Tax.** Amounts distributed in redemption of stock (to the extent allocable to earnings and profits) are deductible as dividends for accumulated earnings tax purposes. Act Section 1804(d) eliminates this deduction for redemptions of
stock of "mere holding or investment companies" other than registered investment companies. The idea is to prevent these companies from avoiding accumulated earnings tax through capital gain distributions. Query whether this provision should be repealed in light of the elimination of preferential treatment of long-term capital gains.

2. **Earnings and Profits.** Act Section 1804(f)(3) clarifies the effective date of the DRA 1984 treatment of earnings and profits adjustments resulting from redemptions. This treatment is effective for distributions made in years beginning after September 18, 1984.

3. **Section 304 Stock Sales.** Section 304(a)(1) provides that stock of one corporation sold to its sister corporation, and subject to Section 304, is treated as transferred to the sister corporation in a contribution to capital. Thus the purchaser takes the stock with a carryover basis. Act Section 1875(b) limits this contribution-to-capital treatment to situations where, because of Section 304, the seller of the stock is
treated as receiving a dividend. Thus, where the selling stockholder has sale treatment under Section 302, the purchasing corporation is deemed to have purchased the stock. Thus Section 338 may apply to such a transaction. Senate Report, 1048. Also, the purchasing corporation will take a cost basis in the stock. Thus the cost basis rule of Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir. 1977), and Rev. Rul. 80-189, 1980-2 C.B. 106, applicable to parent-subsidiary stock sales, is applied to non-dividend brother-sister stock sales.

C. Distributions of Property. Act Section 1804(f)(1) clarifies the earnings and profits consequences of corporate distributions of appreciated property. These are two offsetting adjustments: (1) reduction for the fair market value of the property and (2) increase for the Section 311 gain recognized by the corporation (using earnings and profits basis). Of course, any tax paid by the distributing corporation on its Section 311 gain would also reduce earnings and profits.

D. Spinoffs. Act Section 1810(g) adds a new gain recognition provision by amending Section 367(e). If a corporation makes a Section 355
distribution to a foreign stockholder, the corporation may recognize gain, pursuant to Treasury regulations. With the repeal of General Utilities, the Section 355 stock distribution is one of the few remaining tax-free corporate distributions. This new rule makes even these distributions taxable at the corporate level, if made to foreign stockholders. Thus, depending on the terms of the regulations finally issued, publicly-held corporations may have to ascertain how many of their stockholders are non-United States persons before conducting a spinoff.

E. Liquidations

1. Collapsible Corporations. Act Section 1804(i) eliminates the reference to property held for six months from the collapsible corporation rule. Thus all stock, even short-term stock, is subject to Section 341. The rule is effective for transactions after September 27, 1985. Thus, even before the effective date of the repeal of the long-term capital gain preference, some short-term capital gains may be taxed as ordinary income. This broadening of Section
341 is ironic, in view of the repeal of General Utilities and of the long-term capital gain preference. These changes were supposed to render Section 341 superfluous.

2. Section 332 Liquidations
   a. Eligibility. Act Section 1804(e)(6) conforms the eligibility requirement for Section 332 liquidations to the consolidated return affiliation requirements. The 80% ownership under Section 332, however, still must be direct, unless a consolidated return is filed. Section 332 liquidation treatment is available for corporations which are not eligible corporations under Section 1504(b). Senate Report, 911.
   b. Section 337(c)(3). Act Section 1804(e)(7) conforms the requirements for eligibility of subsidiaries to liquidate under Section 337 to the requirements under Section 332, described above. The purpose is to ensure that, if Section 332 applies to a liquidation of a subsidiary, Section 337 will apply only if the parent also liquidates. Thus, there will be at
least one level of tax. With the repeal of General Utilities, this change has major significance only for transactions between 1985 (1984 for certain electing corporations) and 1986.

3. Section 338. Act Section 1804(e)(8) conforms the definition of "qualified stock purchase" under Section 338 to the consolidated return affiliation requirements. Again, repeal of General Utilities reduces the importance of this change, except for past transactions. (The change is effective for transactions beginning January 1, 1986.)

II. Affiliation Rules for Consolidated Returns and S Corporations

A. DISC Income. Act Section 1804(e)(10) excludes from "includible corporation" status (under Section 1504) corporations which have accumulated DISC income derived after December 31, 1984 (as well as DISCs and former DISCs). Thus, for example, if a former DISC with tainted income merges into another corporation, the survivor corporation will be excluded from consolidation.
Certain S corporations with DISC subsidiaries were "grandfathered" in the Subchapter S Revision Act of 1982. This provision does not affect these situations. Senate Report, 909.

B. Preferred Stock. Code Section 1504(a)(4) excludes certain preferred stock from consideration in determining affiliation. Act Section 1804(e)(1) changes the characteristics of the preferred stock so excluded. Under the new rule, the redemption and liquidation rights of the stock may not exceed the "issue price" of the stock, plus a reasonable redemption premium. Previously, "paid-in-capital or par value" was the measure. "Issue price" of stock is a Section 305 concept, not an accounting concept, and generally it is the fair market value of stock when issued. See, e.g., Rev. Rul. 83-119, 1983-2 C.B. 57; Rev. Rul. 81-190, 1981-2 C.B. 84; Rev. Rul. 76-107, 1976-1 C.B. 89. Thus issue price may be difficult to ascertain.

C. Effective Date. The DRA 1984 revised the consolidated return affiliation rules to require ownership of 80% of value (as well as vote) of subsidiary stock. The new requirement generally applies beginning in 1985. The new rule does not
apply until January 1, 1988, however, for corporations which filed consolidated returns under the old rules as of July 22, 1984. But the general rule (1985), rather than the exception (1988), applies to "sell-downs" of subsidiary stock (other than certain public offerings). DRA 1984 Sections 60(b)(2)-(4). Act Sections 1804(e)(2)-(5) clarify these rules:

1. The exemption until 1988 does not apply as of the first time the subsidiary fails to be affiliated under pre-DRA 1984 rules.

2. The sell-down rules are revised to permit (a) any sell-down (not just a new issue of stock) in the ordinary course of business, (b) any sell-down which does not reduce proportionate ownership of the subsidiary stock by group members, and (c) any sell-down pursuant to underwriting agreements entered into on or before June 22, 1984.

3. The common parent may elect to have the new rule apply for any year beginning after December 31, 1983, even if the subsidiary is eligible for the 1988 exception.
III. Reorganizations

A. Gain and Loss Recognition to Transferor Corporation. Act Section 1804(g) contains a complete rewrite of Section 361. Essentially, under the new rule the transferor recognizes no gain or loss on any property exchange in a reorganization plan. This rule holds for taxable boot, as well as stock and securities, received by the transferor corporation, so long as it is received from a party to the reorganization. The transferor does recognize gain (but not loss), however, if it distributes taxable boot to its stockholders. This is the reverse of old Section 361(b), in which the transferor corporation recognized gain only if it retained the boot. Under the new rule, in recognizing its gain, the transferor corporation takes a basis in the boot it receives equal to carryover basis plus gain recognized by the acquiring corporation. Thus, most boot would have a fair market value basis. Conference Report to Accompany H.R. 3838, H.R. 99-841, 99th Cong. 2d Sess (1986) (the "Conference Report"), II-844. But what about debt instruments of the acquiring corporation? These debt instruments are taxable when distributed, unless they are "securities" exchanged for securities of the transferor. New Code Section 361(c). Will such taxable debt
instruments have a zero basis? If so, the transferor corporation will recognize gain in the full value of the debt instruments when it distributes from them. Ways to avoid this gain might include (a) using cash instead of acquiring corporation debt instruments as boot, (b) having the acquiring corporation sell its debt instruments to a subsidiary, which then transfers the debt instrument to the transferor corporation and (c) having the acquiring corporation purchase stock of the transferor corporation for debt instruments before the reorganization. Also, under the new rule distributions by the transferor corporation of property to creditors are generally treated the same as distributions to stockholders. Conference Report, II-843.

B. Rearrangement of Section 368. Act Sections 1804(h)(1) and (2) move the special “control” rules for type D reorganizations from Section 368(c) to a new Section 368(a)(2)(H).

C. Type C Reorganizations. Act Section 1804(h)(3) makes clear that, in a reorganization “described” in both Sections 368(a)(1)(C) and 368(a)(1)(D), assets may be dropped down to a subsidiary, and the transactions will still retain reorganization status.
D: **Investment Companies.** Act Section 1879(1) changes the requirements for diversified investment companies, which may be parties to a reorganization under section 368(a)(2)(F)(ii). Under the new provisions investment companies are considered to own their ratable shares of assets of RICs, REITs, and diversified investment companies, if they own stock in such companies. Generally, this treatment would make it easier for the investment company at issue to qualify as "diversified."

IV. Financing Transactions

A. **Eurodollar Offerings**

1. **Portfolio Interest.** Act Section 1810(d)(1) narrows the definition of "portfolio interest" to exclude interest not generally subject to 30% withholding. This provision has the effect of narrowing the subpart F exemptions in Section 881(c)(4). Senate Report, 942.

2. **10 Percent Shareholders -- Attribution.** Act Section 1810(d)(2) broadens the constructive stock ownership rules used in determining whether a recipient of portfolio interest is a "10-percent shareholder," ineligible for the withholding exemption.
3. Original Issue Discount (See IV.D., below)

a. Deduction. Act Section 1810(e)(1) amends Section 163(e)(3) to permit taxpayers to deduct original issue discount on obligations held by related foreign persons, if the original issue discount is effectively connected with a U.S trade or business, provided the interest is not tax-exempt or tax-favored by treaty.

b. Taxation. Original issue discount on obligations held by non-U.S. persons is taxed only when a payment is received or the obligation is sold or exchanged. Act Section 1810(e)(2) amends Sections 871(a)(1)(C) and 881(a)(3) to provide that, on a payment, the amount taxable is equal to all original issue discount accrued while the obligation was held by the non-U.S. person and not previously taxed.
B. Bond Premium

1. **Amortization.** Act Section 1803(a)(11) amends Section 171 to require bond premiums to be amortized by the holder (if amortization is elected) on a yield to maturity basis, the same computation as for original issue discount. The effect of this method is to front-end load the amortization deductions, as compared to a straight-line method. See IV E.3, below.

2. **Basis.** Act Section 1803(a)(12) provides that, if a bond is acquired in an exchange basis transaction, other than a reorganization (e.g., a Section 351 exchange), the basis of the bond, for purposes of bond premium, is limited to its fair market value at the time of the exchange.

C. Imputed Interest

1. **Preferential Rate.** Act Section 1803(a)(9) provides that the special 6% rate used to compute unstated interest in certain land sales between related persons will apply before, as well as on and after, July 1, 1985. Previously, the applicable rate before this July 1, 1985, had been 7%.
2. **Pre-July 1, 1985, Transactions.** Act Section 1803(b) clarifies a number of imputed interest rules for transactions subject to the original imputed interest rules of DRA 1984 but not subject to the 1985 amendments to those rules.

3. **Clerical Change.** Act Section 1803(a)(14)(B) clarifies the interaction of Section 483 with the original issue discount rules and Section 1274.

D. Original Issue Discount

1. **Short-Term Obligations**
   
a. **Deduction.** Act Section 1803(a)(4) clarifies current law by stating that a cash basis issuer of a short-term (fixed maturity of one year or less) nongovernment obligation may deduct original issue discount only when it is paid.

   b. **Income -- General.** Act Section 1803(a)(1) provides that a holder of a short-term nongovernment obligation has ordinary income to the extent of gain realized on the sale of the obligation, up to his ratable or proportionate
share of original issue discount. Thus
the general rule of no accrual of
original issue discount income in this
situation continues.

c. **Income -- Section 1281 Persons.** Act
Section 1803(a)(8) makes clear that
certain persons (accrual basis
taxpayers, certain securities dealers,
banks, investment companies, common
trust funds and straddlers) must
include in income all discount on
short-term obligations as accrued. Act
Section 1803(a)(7) adds to the list of
persons subject to Section 1281 persons
who hold stripped coupons or bonds, if
they did the stripping. Act Section
1803(a)(13)(B) contains correlative
amendments to Section 1286.

2. **Publicly Traded Property.** Under Section
1273(b)(3)(B), the issue price of a debt
obligation issued for publicly-traded stock
or securities is equal to the fair market
value of the stock or securities. (A
similar rule applies if the obligation is
issued for non-publicly traded property, but
is itself part of a publicly-traded issue.)
Act Section 1803(a)(10) authorizes regulations under which the same rule would apply to debt obligations issued for publicly traded property other than stock or securities. This rule could apply, for example, to debt obligations issued for commodities or publicly-traded partnership interests. Where applicable, the new rule would replace the less complete imputed interest rules of Section 1274.

E. Market Discount

1. Recognition in Section 351 Exchanges. Act Section 1803(a)(5) amends Section 1276(d) to provide that accrued market discount gain is recognized if a market discount bond is transferred to a controlled corporation under Section 351. This rule applies regardless of whether the transferor receives stock or securities of the transferee corporation. The bond will be a market discount bond in the transferee's hands, if the transferee's basis in the bond is less than the redemption price. Senate Report, 901.
2. **Original Issue Bonds.** Act Section 1803(a)(6) provides a general rule that no market discount is created on the original issue of a bond. For example, a debt security received by a property transferor in a Section 351 transaction may have a basis less than issue price, because the property transferred to the corporation had appreciated. No market discount would be created, however. This general rule does not apply, and market discount may be created, if the bond is acquired (a) with a cost basis or (b) in a reorganization (i.e., a recapitalization), where the property exchanged for the bond is also a bond with market discount. These rules prevent avoidance of the market discount rules by securities wholesalers (who may buy bonds at a discount from the issuer) and in situations where the holder already has a market discount bond.

3. **Partial Principal Payments.** Act Section 1803(a)(13)(A) adds new rules on accrual of market discount on obligations on which there is no more than one principal payment. Accrual of market discount under
this provision is to be in accordance with regulations. The Conference Report, 842, contains accrual rules to be applied until regulations are issued. The same rules are also to apply in amortizing bond premium. See IV.B.1, above.