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Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules

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INTRODUCTION

In order to construct an acceptable system for the taxation of changes in the ownership of incorporated business, one must address the most complex conceptual problems in income taxation. To date, the complexity of that undertaking has precluded the evolution of a coherent, comprehensive system for the taxation of corporate acquisitions. Rather, a variety of patterns of taxation have emerged through largely uncoordinated, ad hoc legislative and judicial development. The resulting system, containing unsupportable distinctions and inconsistencies, is massively complex. Moreover, one consequence of the system is that taxpayers possess a high degree of freedom to tailor the income tax consequences of their acquisitions and thereby minimize their income tax burdens.

A major theme of the current efforts to reform this area of the law has been not only to retain, but also to increase the differences among these patterns of taxation while facilitating the ability of taxpayers to select the pattern desired. It is argued here that both branches of these reforms are misguided. Rather, the variations in the patterns of taxing acquisitions should be eliminated to the maximum possible extent, thereby ending the ability of taxpayers to select their preferred tax consequences. The tax-

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1 The constant complexity, frequent irrationality, and presumptive inadequacy of the taxation of corporate acquisitions belies the importance of the issue, both to the theoretical rigor of the taxing system and to the economy. The manner and weight of the taxation of corporate acquisitions is believed to influence the pace and character of corporate combinations and thus affect the structure of domestic business enterprise. See Tax Aspects of Mergers and Acquisitions: Hearings Before the Subcomm. on Oversight and the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 99th Cong., 1st Sess. 155-56 (1985) (statement of David Brockway); Lewis, A Proposal for a Corporate Level Tax on Major Stock Sales, 37 Tax Notes 1041, 1045 (Dec. 7, 1987).
ing system should contain a mandatory uniform rule for taxing the change in ownership of an incorporated business.

Part I of this article reviews the historic approach to the taxation of corporate acquisitions, illustrating both the significance of the repeal of the General Utilities doctrine to the coherence of the system for taxing acquisitions and the range of the permissible transactional elections. Part II then examines the real, after-tax consequences of an elective system for taxing acquisitions. Cost and carryover patterns of taxation are merely alternative mechanisms for selling the tax attributes and preferences of the corporation being acquired—generally, built-in and operating losses. However, in the current tax environment, electing the cost basis alternative results in an improper reduction of the corporate income tax. Since that option violates sound principles of tax policy, the elective system, whether based upon transactional or express elections, is not appropriate and should be replaced with a uniform mandatory system for taxing corporate acquisitions.

The potential for implementing such a mandatory pattern within our existing separate-entity, double-tax system for taxing corporations is developed in Part III. While difficulties in enforcing any definition of an acquisition must be acknowledged, a mandatory system would be feasible if all acquisitions were taxed as carryover basis transactions at the corporate level. The propriety of that treatment of acquisitions is defended in Part IV. A carryover basis pattern of taxation is the pattern most consistent with the fundamental features of our system for taxing corporations and, in particular, with the pattern previously implemented by the General Utilities doctrine. Since all corporate acquisitions would thus be treated at the corporate level as carryover basis transactions, the proposal herein contemplates the complete repeal of the reorganization provisions of the Code. Part V addresses the shareholder level consequences of a mandatory carryover basis system for taxing corporate acquisitions.

I. Evolution of the Problem

The conceptual difficulty in devising a generally acceptable pattern for taxing corporate acquisitions is attributable to the treatment of corporations as entities entirely separate from their owners and subject to an independent, second level of taxation. The taxation of corporate acqui-

\[\text{General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).}\]
\[\text{IRC § 11.}\]
sitions is the most severe test of the illogic of that two tier system of taxation. The historic inability to fashion a principled and defensible method for taxing such transactions is, quite simply, a natural consequence of the theoretical frailty of that system.\footnote{Full integration of the corporate and shareholder level tax would not necessarily result in abandoning the distinction between cost and carryover basis acquisitions. However, the tax consequences of these two patterns of taxation would be greatly diminished and thus the arguments in favor of two forms of taxation would be greatly weakened. Moreover, the absence of the corporate level tax would largely eliminate the inherent inconsistency in the treatment of stock and asset acquisitions. Some insight into the simplification of corporate acquisitions that integration could provide can be obtained by an examination of the analogous rules governing partnership combinations. See W. McKee, W. Nelson & R. Whitmire, Fed. Tax'n of Partnerships and Partners §§ 15.03[3].}

Under a rigorous application of this separate-entity, double-tax system, transactions in corporate stock would not have any corporate level implications. Rather, the tax attributes of the transferred business would persist notwithstanding the change, regardless of how complete, in the ownership of the incorporated business. Fundamentally, therefore, stock acquisitions are carryover basis transactions at the corporate level. Conversely, asset transfers are fundamentally taxable transactions at the corporate level. A change in the ownership of the business assets so transferred should eradicate the tax attributes of those assets, subject the transferor to a full tax on the appreciation in the assets, and produce a cost basis for the assets in the hands of the acquiring corporation. Despite this inherent inconsistency in the nominal patterns for taxing stock and asset transfers, wide agreement exists that the financial effect of stock acquisitions and asset acquisitions are far too similar to justify the application of such distinct patterns of taxation.

Moreover, while sales of assets are fundamentally taxable transactions, the mere continuation of a business, of course, is not. An asset acquisition of an entire business activity resembles a taxable sale only when viewed from the perspective of the legal entities of the transferor and transferee corporations. From the perspective of the business itself, an asset acquisition accomplishes little of substance: The assets remain intact, in corporate solution, and perhaps largely owned by the same shareholders. Given certain conditions, an asset acquisition may more nearly resemble the mere continuation of a single corporation than a sale of those assets, and thus, ought not be subject to tax.

Historically, the taxing system has accepted each of these models for taxing corporate acquisitions. Prior law, however, responded to the potential discontinuities in the tax consequences of the varied models with the evolution of ad hoc doctrines. The general effects of those doctrines were (1) to minimize the extent of the discontinuity, and (2) to permit taxpayers to select from among a range of tax consequences arising from
their transactions. The ability of taxpayers to elect among patterns of taxation further muted the significance of the remaining discontinuities.

The central feature of the historic effort to bridge the discontinuity in the taxation of the different forms of stock and asset acquisitions was the \textit{General Utilities} doctrine. Under that doctrine and its statutory extensions, the corporate level tax on asset acquisitions was excused, thus, to that extent, conforming the consequences to the transferor in an asset acquisition to the consequences of a stock acquisition. Further, the \textit{General Utilities} doctrine muted the distinction between the patterns of taxing "taxable" sales of assets and nontaxable continuations or "reorganizations." While successful in that effort, in practice, however, the \textit{General Utilities} doctrine seemed to create distortions as serious those it eliminated. The doctrine ultimately was repealed in 1986.

The repeal of the \textit{General Utilities} doctrine, however, was not accompanied by the adoption of an alternative system for reconciling the consequences of the variety of forms of stock and asset acquisitions. Repeal, therefore, has materially increased the range of possible tax consequences of an acquisition while eroding the coherence of the statutory scheme. Replacing the harmonizing theme provided by the \textit{General Utilities} doctrine has proven to be difficult. The doctrine reflected the consensus that prevailed during the first 73 years of our income taxation of corporations: Unrealized appreciation in incorporated assets ought not be subject to tax merely because of a change in ownership of a business. That notion was central to both of the primary systems for taxing an acquisition that have emerged. The precipitous repeal of that doctrine in all of its manifestations marks the dissolution of that consensus. The commentators today are deeply divided over the proper approach to be taken in the taxation of corporate acquisitions. In 1986, Congress instructed the Treasury Department to study and present proposals for revising the system for taxing all corporate acquisitions, including the highly fragmented "reorganization" provisions. That study, which was to be completed

\begin{itemize}
\item[6] IRC § 337 (before repeal in 1986) [hereinafter Old § 337]. See text accompanying note 16.
\item[7] Corporate acquisitions falling within the definitions contained in § 368(a). See text accompanying notes 27-29.
\end{itemize}
by January 1, 1988, has yet to appear, but is still expected.\textsuperscript{11}

\textbf{A. Nonreorganization Acquisitions}

Prior to 1986, in a "taxable" acquisition, one not governed by the reorganization provisions of the Code, only a single level of tax was imposed upon the target corporation and its shareholders in either a stock or an asset acquisition. The corporate level tax was imposed only in the relatively uncommon circumstances in which the form of the transaction prevented the imposition of a shareholder level tax.\textsuperscript{12}

In large part, this pattern of taxation derived from an initial misunderstanding of the concept of income. From the inception of the income tax, it was generally understood that a unilateral transfer of appreciated property, not in exchange for a consideration, did not result in taxable income to the transferor. Since the transferor did not receive anything tangible in exchange for the property, the transferor was not viewed as benefitting from the appreciation in the transferred property; therefore, he should not be subject to tax. As a result, neither donors of appreciated property to their children\textsuperscript{13} nor corporate distributors of appreciated property to their shareholders were subject to tax. In the corporate context, this understanding became associated with the decision of the Supreme Court in \textit{General Utilities & Operating Co. v. Helvering},\textsuperscript{14} and became known as the \textit{General Utilities} doctrine.

While born of a confusion between the concepts of income and of realization, the \textit{General Utilities} doctrine did not persist for three-quarters of a century because of that early lack of sophistication. Rather, the doctrine, and its subsequent statutory expansion, reflected a generally held, but not fully articulated, sense that it was inappropriate and excessive to bring the full burden of the double tax system to bear upon the disposition of an incorporated business regardless of the form of the dispositive transaction.\textsuperscript{15} That general understanding shaped the development of the Internal Revenue Code of 1954—the only occasion in which Con-

\textsuperscript{11} 42 Tax Notes 7-8 (1989).

\textsuperscript{12} The corporate tax exemption provided by Old § 337 did not apply if the target corporation was not liquidated in order to avoid a tax at the shareholder level or if the shareholder was a corporate parent which would not be subject to tax upon the liquidation of a subsidiary under § 332.

\textsuperscript{13} See Irwin v. Gavit, 268 U.S. 161 (1925). Similarly, an estate is not subject to tax on the appreciation in property used to satisfy the bequest of a fractional share of the estate. Reg. § 1.661(a)-2(f)(1).

\textsuperscript{14} In fact, both the government and the Court assumed the propriety of the tax exemption. The case involved exceptions to the rule that apparently had existed since the inception of the tax.

\textsuperscript{15} For one expression of this view, see Nolan, Taxing Corporate Distributions of Appreciated Property: Repeal of the \textit{General Utilities} Doctrine and Relief Measures, 22 San Diego L. Rev. 97 (1985).
gress ever attempted an overall restatement of the rules governing cost basis acquisitions.\textsuperscript{16}

Under the 1954 Code, the logic of the \textit{General Utilities} doctrine was extended to encompass sales of assets at the corporate level providing only that a full compensating shareholder level tax was imposed. Thus, under the pre-1986 version of § 337, the corporate level tax was not imposed upon sales of assets by a nonsubsidiary corporation if the target corporation was promptly liquidated in a transaction that subjected its shareholders to tax.\textsuperscript{17} As a result, the tax imposed upon an asset acquisition was conformed to the level of taxation of stock acquisitions.

Acquisitions accomplished through stock purchases, of course, had never resulted in the imposition of a corporate level tax. However, the separate entity concept also prevented any adjustment to the basis of the assets of the purchased corporation. That carryover basis pattern of taxation, however, was inconsistent with the basis adjustment that was obtained in an asset acquisition—although both were subject to the same burden of a single shareholder level tax. Accordingly, in 1954, Congress followed the lead of the judiciary\textsuperscript{18} and expressly permitted acquiring corporations to treat stock purchases as asset purchases. Thereafter, upon an acquisition through a stock purchase, the acquiring corporation could, through a transactional election that required the liquidation of the target corporation,\textsuperscript{19} obtain a cost basis for the assets acquired—

\footnotesize{16 Prior to 1954, the \textit{General Utilities} doctrine excused unrealized appreciation from the corporate level tax when assets were removed from corporate solution through a distribution to shareholders. On the other hand, nothing eliminated the corporate tax if assets were sold at the corporate level even though the proceeds of the sale were distributed, and fully taxed, to shareholders. Taxpayers responded to this discontinuity by somewhat cumbersomely structuring acquisitions as liquidations in kind followed by shareholder level sales of the “distributed” assets. After first casting doubt on the validity of this tax reduction technique in Commissioner v. Court Holding Co., 324 U.S. 331 (1945), the Supreme Court ultimately concluded that this circuitous transaction effectively eliminated the corporate level tax on acquisitions. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). The resulting acquisitive technique was, however, absurd, and, in the 1954 recodification of the tax laws, Congress eliminated its necessity.

17 The one exception to this pattern was for collapsible corporations as defined in § 341. Since Congress wished to ensure that the gain in the assets of such a corporation was subject to ordinary income taxation, collapsible corporations were not eligible for nonrecognition of gain under Old § 337.

18 In Kimbell-Diamond Milling Co. v. Commissioner, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951), the government, in a routine application of the step transaction doctrine, successfully argued that a stock purchase followed by a liquidation should be treated as an asset purchase. In later cases, however, taxpayers invoked the doctrine. See, e.g., American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968). The legislative history to the 1982 revision of the statutory rule purports to bar the application of the judicial rule to achieve a stepped-up basis outside the provisions of § 338. Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, 133 (Comm. Print 1982).

19 IRC § 334(b)(2) (before amendment in 1986).}
again, without the imposition of any corporate level tax.

In the years following 1954 there was some uncertainty concerning the theoretical underpinnings of the pattern of taxation adopted by Congress. Some viewed the extension of the General Utilities doctrine as the mere acknowledgement that the corporate level tax was avoidable, and as the creation of a statutory procedure for making that avoidance less expensive and more widely available.\(^{20}\) That view, however, ignored the range of options available to Congress in 1954 and the deliberate choice enacted into law.\(^{21}\) At that time, Congress could have, had it so chosen, followed the path ultimately taken in 1986.\(^{22}\) That Congress did not so proceed was significant. The 1954 legislation was not the mere ratification of a species of tax avoidance. Rather, it was a clear manifestation of the general understanding that the logic of the double tax system did not require the imposition of both levels of tax upon the change in ownership of an incorporated business, but did require the neutral treatment of stock and asset acquisitions.

The 1954 legislation resulted in a consistent pattern for taxing nonreorganization corporate acquisitions that remained essentially unchanged for over 30 years. However, over a period of time, it became clear that while the 1954 solution had eliminated discontinuities among acquisitive techniques, it had created unacceptable discontinuities between the pattern of taxing acquisitions and the pattern of taxing continuing business activities.\(^{23}\) Excusing the corporate tax on the gain inherent in corporate assets upon a change in ownership, while imposing the tax on that gain when realized by a continuing corporation, appeared to create a substan-

\(^{20}\) The Supreme Court itself so erred in Central Tablet Mfg. Co. v. United States, 417 U.S. 673 (1974). There, the corporate taxpayer sought to avoid taxation on the receipt of insurance proceeds following the destruction of its properties by fire under Old § 337. The Court, however, barred the tax exemption noting that this taxpayer could not have avoided the corporate level tax by distributing its properties to its shareholders. Since the taxpayer could not have benefited from the Cumberland Public Services application of the General Utilities doctrine, the taxpayer fell outside of the scope of the Old § 337 version of the doctrine.

Four years later, Congress reversed the result in Central Tablet by adding subsection (e) to Old § 337. That congressional action reflected the equitable conclusion that taxpayers like Central Tablet ought not to be subject to double taxation.

\(^{21}\) See Wolfman, Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine, 22 San Diego L. Rev. 81, 82 (1985) ("Everyone in the tax world knew that when Congress came to review the problems of corporate taxation in 1954, the General Utilities doctrine would either be overruled or codified.").

\(^{22}\) Discarding the General Utilities doctrine entirely and imposing a corporate level tax upon all distributions of appreciated property to shareholders equally would have conformed the consequences of corporate level asset sales to the consequences of sales following an in-kind liquidation—but only at the cost of creating different tax consequences for stock and asset acquisitions.

\(^{23}\) The impropriety of that discontinuity has been pointed out most forcefully by the American Law Institute and its Reporter, Professor William Andrews. See Subchapter C Project, note 9, at 111-19.
tial bias in favor of corporate acquisitions. Thus, many argued, the taxing system was subsidizing and encouraging corporate takeover activity and the formation of conglomerate enterprise.\(^{24}\) In addition, the general acceptance of the *General Utilities* doctrine had been gradually eroded by a well publicized series of highly aggressive transactions in which taxpayers sought to extend the scope of the doctrine.\(^{25}\) In 1986, continuing unease over the past abuses of the rule combined with the need for revenue from the corporate sector, and, with the encouragement of those

\(^{24}\) See H.R. Rep. 426, 99th Cong., 1st Sess. 281-82 (1985). At first it appeared that this bias would be effectively eliminated through the disappearance of the corporate level tax. During the 1970's a considerable sentiment began to emerge in favor of relieving, if not eliminating, the corporate tax through one or another form of integration. See e.g., Treasury Department, Blueprints for Basic Tax Reform (1977). Integration, however, was opposed both by corporate managers, who feared increased pressure for the distribution of dividends, and by the high tax bracket owners of closely held corporations, who used the lower rates of the corporate tax in combination with the preferential rate of tax on capital gains as an effective tax shelter. See Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process, 8 Va. Tax Rev. 57, 70 (1988); Leonard, Pragmatic View of Corporate Integration, 35 Tax Notes 889, 895 (June 1, 1987); Warren, the Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 719 (1981).


Five years later, in one of the violent shifts in policy that has seized tax legislation in recent years, the significance of the corporate tax was resurrected. An unlikely marriage among conservative supply side economists, the ancient advocates of a more comprehensive definition of the tax base, and modern antagonists of the tax shelter industry produced a substantial revision, if not reform, of the individual income tax. See J. Birmbaum & J. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists and the Unlikely Triumph of Tax Reform (1987); Bittker, Tax Reform—Yesterday, Today, and Tomorrow, 44 Wash. & Lee L. Rev. 11 (1987). The revenue loss resulting from the lower, and flatter, rate structure enacted in 1986, however, was unacceptable in light of the current federal budgetary deficits. See Handler, Budget Reconciliation and the Tax Law: Legislative History or Legislative Hysteria?, 37 Tax Notes 1259, 1263-64 (Dec. 21, 1987). That revenue need, coupled with popular antagonism towards the excesses of the 1981 corporate tax reduction, inevitably resulted in a major strengthening of the corporate income tax. See Minarik, How Tax Reform Came About, 37 Tax Notes 1359, 1364 (Dec. 28, 1987).

As one result, the taxation of corporate acquisitions again became a matter of concern.

\(^{25}\) The exemption from the corporate level tax for sales of assets was available only if the target corporation completely liquidated, thus subjecting its shareholders to tax upon the entire amount of their gain. Taxpayers seeking to avoid this limitation began to exploit the exemption from the corporate tax that attached to nonliquidating distributions. In 1969, systematic redemptions of public shareholders with appreciated property precipitated an amendment to § 311(d) to tax the appreciation to the distributing corporation. By 1986, public corporations had progressed to selling subsidiaries by causing the prospective purchaser to first acquire stock of the target's parent which would be redeemed in exchange for the stock of the subsidiary to be acquired. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988).
seeking to end acquisitions inspired by the discontinuity in the corporate tax, produced the complete repeal of the *General Utilities* doctrine.

The precipitous imposition of a full corporate level tax on acquisitive transactions eliminated one discontinuity in the taxation of corporations. However, enacted in isolation, the repeal left the broad pattern for taxing those transactions in disarray. Most prominently, the 1986 legislation destroyed the tax neutrality between stock and asset acquisitions, which had been the hallmark of the 1954 solution. In addition, the legislative modifications in the manner of taxing acquisitions created a substantial disparity between the patterns of taxing cost and carryover basis acquisitions, thus greatly increasing the range of the optional tax consequences from which taxpayers could choose.

B. Reorganizations

While the rules so governing "taxable" acquisitions developed as relatively minor adaptations of the general principles of income taxation, from almost the inception of the income tax, Congress has authorized a special scheme for taxing a subcategory of corporate acquisitions. If the consideration paid by the acquiring corporation consisted of a specified proportion of acquiring corporation stock, either a stock or an asset acquisition might be treated as a carryover basis transaction at the corporate level. Moreover, for those shareholders of the target corporation who received stock in the acquisition, the exchange might also be treated as a carryover basis transaction at the shareholder level. Thus, in a reorganization, the corporate level tax was not excused because of the application of a shareholder level tax. Rather, the tax was excused be-

26 Just four years before, the taxation of stock acquisitions had been extensively revised on the assumption that acquiring corporations in general would seek a cost basis for the acquired assets, a result that was facilitated through the adoption of a relatively straightforward express election to replace the requirement that the target corporation be liquidated. IRC § 338. However, with the subsequent repeal of the *General Utilities* doctrine, the price for achieving that basis adjustment became a full corporate level tax—a price that few were prepared to bear. As a result, in actual practice, the objective in a stock acquisition became avoiding the unintentional election of the simplified procedure enacted four years previously and preserving carryover basis treatment.

The purchaser of stock was left with the ability to elect between cost and carryover basis transactions, but the tax cost of electing cost basis treatment had become so high that the election could only be made in special circumstances. On the other hand, the repeal of the *General Utilities* doctrine treated all nonreorganization asset acquisitions as fully taxable, cost basis acquisitions.

27 Under the judicially developed continuity of proprietary interest doctrine, a reorganization within the meaning of § 368 could not occur unless shareholders of the target obtained a meaningful equity interest in the acquiring corporation. See *LeTulle v. Scofield*, 308 U.S. 415 (1940). For most forms of acquisitive reorganizations, this judicial doctrine has been codified and strengthened in § 368.

28 IRC § 381.

29 IRC §§ 354, 358.
cause the transaction might properly be viewed as more nearly resembling the continuation of the target corporation than a taxable disposition by that corporation.

In general effect, these so-called reorganization provisions permitted the parties to an acquisition to elect to defer all or a part of the shareholder level tax otherwise payable, but only at the cost of converting the exemption from the corporate level tax obtained in a cost basis acquisition into a mere deferral of that tax through the mechanism of a carryover basis. While qualifying an acquisition as a reorganization might materially benefit the stockholders of the target corporation, prior to 1986, the significance of obtaining that treatment at the corporate level was limited.

In a stock acquisition, carryover basis treatment could be received regardless of whether the acquisition constituted a reorganization; therefore, reorganization classification was of little concern. In an asset acquisition of a profitable target corporation, reorganization treatment avoided taxation of the target. However, under the General Utilities doctrine, the target would not in any event have been taxed on the appreciation in the value of its assets. Prior to the repeal of that doctrine, a developing mix of case law and statutory rules required that the operating income of the target corporation for its final year be adjusted under tax benefit principles. For example, if the target had claimed tax deductions for depreciation or the purchase of supplies that had not been supported by the time of the acquisition by economic consumption, the target was required to include in income the excess of the deduction over the economic loss. Reorganization treatment deferred the making of that tax benefit adjustment to income, but only at the cost of forgoing an increase in the basis of the target assets. On the other hand, qualifying an asset acquisition of a target having operating losses as a reorganization could be of greater importance. The loss carryover would survive the acquisition only in a carryover basis acquisition and that could only be achieved pursuant to the reorganization provisions.

In general, therefore, during the era dominated by the General Utilities doctrine, the tax differences between taxable and reorganization treatment at the corporate level were not as great as might be supposed. The repeal of that doctrine, however, has greatly magnified those differences. Significantly, under prior law, as today, the ability to elect between cost and carryover basis treatment is primarily of significance to target corporations having operating losses for sale.

30 The depreciation recapture rules of § 1245 overrode the nonrecognition provisions of Old § 337. Reg. § 1.1245-6(b).
In contrast to the comprehensive revision of the rules governing taxable acquisitions which occurred in 1954, the rules governing reorganizations have never been revised. To the contrary, those rules have been continually subject to ad hoc amendments—often, to extend reorganization treatment to specific new forms of acquisitive transactions. As a result, the reorganization provisions have come to consist of a bewildering array of inconsistent and sometimes irrational statutory provisions supplemented by case law doctrine and administrative practice. A catalogue of the enormous inadequacies in the reorganization provisions is unnecessary for the purposes of this article. However, if the proposal here to repeal those provisions were not adopted, a pressing need to reform those provisions would remain.

C. Transactional Election

Under present law, the income tax consequences of an acquisition are almost completely within the control of the parties. The traditional pattern of taxing corporate acquisitions has involved the drawing of a complex series of definitional lines across the continuum of acquisitive transactions at relatively arbitrary points. Because of the highly arbitrary manner by which cost and carryover basis acquisitions are thereby distinguished, the parties to an acquisition are free to adjust the tax consequences of the transaction to achieve the result they desire by making only highly insubstantial changes in the underlying form of the acquisition.

33 See Senate Report on Subchapter C, note 9, at 37-38.
34 For one treatment, see Posin, Taxing Corporate Reorganizations: Purging Penelope's Web, 133 U. Pa. L. Rev. 1335 (1985). Also see Subchapter C Project, note 9, at 22-28; Senate Report on Subchapter C, note 9, at 37-38.
36 The reorganization provisions of the Code, for example, are not elective in form; in fact it may be the Commissioner who asserts their application. See, e.g., McDonald's Restaurants, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982). Nevertheless, in practice, obtaining the reorganization pattern of carryover basis taxation is entirely elective by transactional form. The definitions of both the stock and asset acquisitions that constitute reorganizations are rigid and highly arbitrary. With insignificant exceptions, both stock and nonmerger asset acquisitions, for example, require that the sole consideration for the acquisition payable to the target corporation or its shareholders must be voting stock of a single acquiring corporation. As a result, taxpayers can obtain reorganization treatment by adhering to the statutory requirements or can avoid that treatment by making economically trivial changes in the form of the acquisition.

The elective feature of existing law is enhanced by the fact that an asset acquisition may occur either by a statutory merger under state law or by a nonmerger asset transfer. While the end result of both forms of acquisitions is identical, the tax law requirements for reorganization type carryover basis treatment of these two formats vary widely.
The range of the resulting elections under current law readily appears from a simplified synthesis of the primary rules governing the taxation of corporate acquisitions. At the corporate level, carryover basis can be obtained through either any manner of stock acquisition or an asset acquisition that constitutes a reorganization. In such a carryover basis acquisition, the consequences at the shareholder level may be either taxable or nontaxable. If the acquisition is of stock, the shareholder level transaction can be made taxable by using a trivial amount of nonstock consideration, or can be made nontaxable if the consideration is solely voting stock. In a carryover basis asset acquisition, the transaction must, in form, be nontaxable at the shareholder level, but only for perhaps a majority of the target shareholders. However, there is little to bar even those shareholders from disposing of the stock received and thus creating a taxable transaction. The remaining shareholders may receive either taxable or nontaxable consideration.

A cost basis also can be obtained at the corporate level following either a stock or an asset acquisition by avoiding reorganization treatment. In such an acquisition, the shareholder level transaction, in form, must be taxable. However, following an asset acquisition, the results of carryover basis at the shareholder level can be approximated either by not liquidating the target corporation or, in some cases, by deferring the shareholder tax on a liquidation of the target through the use of the installment method of reporting gain. If the acquisition were of stock,

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37 See Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980).

38 Today, a carryover basis asset acquisition is only possible in a reorganization described in § 368(a)(1)(A) or (C). For a reorganization to occur, a substantial portion of the consideration must be nonrecognition property.

39 In a merger-type asset acquisition, only the judicial continuity of interest rules apply. Thus, a substantial portion of the consideration received by the target shareholders must be nonrecognition property; the balance, however, may be taxable. See note 27 and accompanying text.

40 Compare Penrod v. Commissioner, 88 T.C. 1415 (1987), with McDonald's Restaurants, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

41 A cost basis election can be made under § 338.

42 An election under § 338 cannot be made unless the acquiring corporation purchases 80% of the stock of the target in a taxable transaction. IRC § 338(h)(3).

43 Prior to the repeal of the General Utilities doctrine, target corporations were normally liquidated following an asset sale in order to obtain the benefits of Old § 337. The repeal of that section has largely eliminated the benefit of such liquidations and thus has facilitated the deferral of tax at the shareholder level.

44 Under § 453(h), if the target assets are sold for notes of the acquiring corporation the gain on which is reportable on the installment method, the target shareholders may be entitled to defer the taxation of their gain on the liquidation of the target until payments are made on the notes. However, there are several limitations on the use of the installment method that may bar this relief. For example, if the acquiring corporation notes are "readily tradable," installment reporting is not available. IRC § 453(f)(4). The result is less clear if the stock of the target corporation was readily tradable. Under § 453(k)(2), gain on the sale of traded securities is not eligible for installment reporting. The liquidation of the target is an exchange,
similar but somewhat more limited possibilities for deferral of tax through installment reporting also exist. Moreover, up to 20% of the target shareholders may escape taxable treatment either by not tendering their target stock or by engaging in a complex transaction sheltered from tax by § 351.

D. Summary

The separate-entity, double-tax system yields competing models for the taxation of corporate acquisitions; the notion that an acquisition essentially may be a mere continuation of the enterprise yields others. Historically, the taxing system has adopted all of those models, thus creating a massive, complex, and uncoordinated system for taxing corporate acquisitions. Nevertheless, at least at the corporate level, the historical differences among the tax consequences of acquisitions were far less than might have appeared. Today, by contrast, with the repeal of the General Utilities doctrine, the differences in the tax consequences between cost and carryover basis acquisitions is substantial; far greater than at any previous time. Secondly, the parties to an acquisition have almost complete freedom to select the desired pattern of taxing their transaction from among these alternatives. Under present law, therefore, the parties to an acquisition have the ability to choose from a wide range of tax consequences for their transaction at both the corporate and shareholder levels. Aside from the inability to select and enforce a single pattern for taxing acquisitions, why any election of tax consequence should be extended is far from evident.

One obvious consequence of this multifaceted statutory pattern of taxation is the enormous complexity of the tax rules governing acquisitions. A less apparent consequence is that the ability to design the tax consequences of an acquisition, and thus minimize the income tax burden of a transaction, inevitably results in a loss of tax revenue in comparison to any uniform system for taxing acquisitions. A principal source of the

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45 Unless the target has a very small number of shareholders, notes issued by the acquiring corporation to those shareholders quite likely will be readily tradable and thus ineligible for installment reporting.

46 Shareholders wishing to defer tax may contribute their target stock to a newly formed subsidiary of the acquiring corporation in a nontaxable exchange for any type of stock of that subsidiary in a § 351 exchange. Rev. Rul. 84-71, 1984-1 C.B. 106.

47 In practice, other possible combinations of results are possible. For example, the acquiring corporation may treat the acquisition as a taxable purchase, resulting in a cost basis, while the shareholders may inconsistently report the transaction as a reorganization. See, e.g., King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969).
resulting under-taxation is demonstrated in the following portion of this article.

II. CORPORATE LEVEL ELECTION

The difficulty in deriving a single, theoretically rigorous approach to the taxation of corporate acquisitions has caused many students of this intractable corner of the tax law to endorse granting to the parties to an acquisition an express election between cost basis and carryover basis consequences at the corporate level. Such a position was explicitly adopted by the American Law Institute in 1982 and has obtained some acceptance by the staff of the Senate Finance Committee. In general, the ALI proposed replacing the complex and uncertain transactional elections of present law with an express election between taxable, cost basis and tax-free, carryover basis patterns of taxation at the corporate level that would apply to all corporate acquisitions.48 Those proposals, which would substantially improve present law, have become the starting point, or foil, for subsequent efforts at reform. Nevertheless, expressly elective treatment is justifiable only if the transactional elections to be rationalized are themselves justifiable.

Elective treatment would appear defensible if it were concluded that both of the patterns that might be elected (that is, cost and carryover basis) were appropriate patterns of taxation or, at least, that the presence of both patterns was unavoidable and might as well be rationalized.49 Even if both patterns of taxation, in isolation, might appropriately be invoked in the taxation of corporate acquisitions, however, it does not necessarily follow that an election between those patterns is appropriate. This part examines the consequence of permitting such an election under the current pattern of taxing corporations generally.

A. Benchmark Consequences of an Acquisition

In an elective system for taxing acquisitions, the pattern of taxation selected by the parties under normal conditions will be carryover basis. That pattern will be chosen because, if both parties to the transaction face the same effective rates of taxation, a carryover basis acquisition will be more favorable by the value of the deferral of the tax liability that would be imposed upon a cost basis acquisition. Viewing the matter from the other perspective, the benefit that the acquiring corporation obtains from the making of a cost basis election is an increase in the tax basis of the transferred properties. That increase, of course, translates

48 Subchapter C Project, note 9, at 43.
49 The American Law Institute appears to so view the matter. See Subchapter C Project, note 9, at 36-41.
into an increase in the offsets and deductions against its taxable income from loss, depreciation, or other cost recovery allowances. On the other hand, the detriment that the target corporation suffers from the cost basis election is the immediate imposition of a tax on precisely the same amount. Since the present value of that tax burden will inevitably be greater than the present value of the deferred tax benefit from the greater cost recovery allowances, under normal conditions the cost basis election will produce an increase in the overall tax liabilities of the parties to the acquisition relative to the burden of a carryover basis election.

The election of carryover basis treatment, however, does not mean that the target corporation completely avoids the burden of the corporate tax on the appreciation in its properties. To the contrary, the deferred income tax attributable to the appreciation inherent in the assets of the target corporation constitutes a liability of the target corporation that must ultimately be borne by that corporation regardless of the immediate tax consequences of the transaction. In a cost basis acquisition, an explicit, recognizable tax is imposed upon the target corporation that directly reduces the net proceeds of the transaction. In contrast, in a carryover basis acquisition, the deferred obligation to pay that tax is assumed by the acquiring corporation. The lower tax basis for the transferred properties will result in an increase in taxable income. Ultimately, the acquiring corporation will bear an increased tax liability that will approximately equal the tax that would have been imposed upon the target corporation in a cost basis acquisition. Because the acquiring corporation in a carryover basis acquisition thus will assume a tax liability that it would not assume in a cost basis acquisition, the purchase price in a carryover basis acquisition rationally must be made less than the price that would be paid in a cost basis acquisition by the present value of the deferred tax liability assumed. The difference be-

50 Both the gain taxable to the target and the basis increase received by the acquiring corporation must equal the excess of the value of the target properties over their aggregate adjusted bases.

51 The "tax" imposed on the acquiring corporation in a carryover basis acquisition attributable to the receipt of target assets having a carryover basis will not commonly be an actual tax imposed on gain generated by a disposition of those assets. Rather, the reduced basis of the assets will result in a reduction of the depreciation or other cost recovery allowances available to the acquiring corporation, and thus, will cause an increase in the income or gain realized by the corporation.

Unlike the immediate tax imposed as the result of electing a cost basis acquisition, however, this increase in taxable income will not be entirely realized in the year of the acquisition. Rather, that increase will be realized over the period of time during which the acquired assets are depreciated. As a result, the present value of the interest-free deferred tax liability to the acquiring corporation will be considerably less than the element of appreciation multiplied by the acquiring corporation's marginal tax rate.

52 To illustrate, assume that the assets of the target corporation have a fair market value of $100 in the sense that the assets could be sold for that amount in a fully taxable transaction and that the aggregate tax bases for these assets is $40. Both the target and the acquiring
between the purchase prices that will be paid in cost and carryover basis acquisitions constitutes an implicit tax imposed upon the target corporation.\textsuperscript{53}

The relationship between the implicit tax imposed in a carryover basis acquisition and the explicit tax imposed in a cost basis acquisition depends upon the relative negotiating strengths of the parties to the acquisition. The difference between the present value of the deferred tax
corporation face a marginal rate of tax of 33% and that tax cannot be deferred indefinitely. The following chart summarizes the tax consequences at the corporate level of a fully taxable, cost basis acquisition.

<table>
<thead>
<tr>
<th>Cost basis</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$100</td>
</tr>
<tr>
<td>Basis</td>
<td>40</td>
</tr>
<tr>
<td>Gain</td>
<td>60</td>
</tr>
<tr>
<td>Tax on Target</td>
<td>20</td>
</tr>
<tr>
<td>Proceeds to shareholders</td>
<td>80</td>
</tr>
<tr>
<td>Basis to Acquiring</td>
<td>100</td>
</tr>
<tr>
<td>Deferred gain</td>
<td>0</td>
</tr>
</tbody>
</table>

If the acquisition had been conducted as a carryover basis acquisition, the consequences of the transaction would be changed as follows.

<table>
<thead>
<tr>
<th>Carryover basis</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>80</td>
</tr>
<tr>
<td>Basis</td>
<td>40</td>
</tr>
<tr>
<td>Gain</td>
<td>0</td>
</tr>
<tr>
<td>Tax on Target</td>
<td>0</td>
</tr>
<tr>
<td>Proceeds to shareholders</td>
<td>80</td>
</tr>
<tr>
<td>FMV assets to Acquiring</td>
<td>100</td>
</tr>
<tr>
<td>Basis to Acquiring</td>
<td>40</td>
</tr>
<tr>
<td>Deferred gain</td>
<td>60</td>
</tr>
<tr>
<td>Tax</td>
<td>20</td>
</tr>
<tr>
<td>Total cost of assets</td>
<td>100</td>
</tr>
</tbody>
</table>

In a carryover basis acquisition, the assets of the target contain, in the hands of the acquiring corporation, the same element of appreciation that the assets had in the hands of the target. As a result, the acquiring corporation necessarily assumes the liability of the target to pay the same amount of income tax that would have been imposed upon the target in a taxable, cost basis acquisition. See Staff of Joint Comm. on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions 10 (Comm. Print 1985).

\textsuperscript{53} If the acquiring corporation is subject to a low rate of tax, or is exempt from taxation, the relationship described in the text will be disturbed. First, because the acquiring corporation will not be subject to an explicit tax, it may not impose an adequate implicit tax on the target. The possibility that tax-exempt purchasers may outbid taxable purchasers for the target assets, however, is a universal problem. See e.g., Brown v. Commissioner, 380 U.S. 563 (1965).

Of greater present concern, a tax-exempt acquiring corporation may be able to convert the deferral of tax in a carryover basis acquisition into a permanent exemption from tax. That result might occur, of course, in either an elective or mandatory carryover basis scheme and thus should be addressed without regard to the proposal here. In an important recent amendment to the Code, Congress has barred the use of operating losses of acquiring corporations to offset the tax on the built-in appreciation in the target assets which greatly diminishes the scope of this potential erosion of the corporate tax base. IRC § 384. See also IRC §§ 367 (foreign purchasers), 512 through 514 (exempt organizations).
liability assumed in a carryover basis acquisition and the explicit tax imposed in a cost basis acquisition represents the tax savings resulting from the carryover basis election. If the entire benefit of those tax savings is retained by the acquiring corporation, the implicit and explicit taxes imposed upon the target will be identical. To the extent that the tax savings are passed to the target corporation through an increase in the purchase price, the implicit tax will be less than the explicit tax.

B. Conditions Favorable to a Cost Basis Election

The parties to an acquisition will prefer a cost basis acquisition only if electing that pattern of taxation results in one party's being made better off and the other party not being made worse off. That condition will only occur when volunteering the explicit tax will result in a burden of taxation on the acquisition that is less than the tax burden that would be imposed in a nonrecognition, carryover basis acquisition. That reduction in overall tax burden can be obtained only if the effective rate of tax on the target corporation is lower than the effective rate of tax facing the acquiring corporation. If, because of that lower rate, the explicit tax imposed upon the target corporation is less than the present value of the tax benefits obtained by the higher rate acquiring corporation from the increase in tax basis produced by the cost basis election, the election may provide an overall benefit to the parties. By yielding a portion of the tax benefit from the resulting increase in basis, the acquiring corporation may be able to fully compensate the target corporation for the explicit tax imposed by virtue of the cost basis election. In that event, both corporations can be made better off under the cost basis election than they would have been in a carryover basis acquisition.

Historically, a number of different features in the pattern of taxing corporations might have produced a low marginal rate of tax on target

54 In the example used above in note 52, the tax benefit to the acquiring corporation from the $60 increase in basis may be assumed to have a present value of $15. If the rate of tax imposed upon the target were also 33% resulting in a tax of $20, the acquiring corporation could not rationally reimburse the target for the full amount of that tax. However, if the effective rate of tax upon the target was 25%, the tax cost of a cost basis acquisition would decline to below $15. If the acquiring corporation increases the purchase price from the amount that would be paid in a carryover basis acquisition by the present value of the tax benefits obtained from the election, i.e., $15, the acquiring corporation will not be made worse off than it would be under carryover basis, while the target will have obtained a full reimbursement for the explicit tax. Subtracting an explicit tax of $15 from a purchase price of $95 would leave the target with net proceeds available for distribution to its shareholders of $80. Because that amount equals the amount the target shareholders would be able to receive in a carryover basis acquisition, the parties will be indifferent between electing a carryover basis or a cost basis acquisition.
corporations in cost basis acquisitions. In the current tax environment, however, the most common explanation for a low rate of tax upon a target corporation will be the existence of net operating losses in the target or the consolidated group of which it is a member. If the gain produced by a cost basis acquisition can be absorbed in whole or in part by loss carryforwards available to the target, its overall tax burden may be reduced to an amount less than the tax benefit obtained by the acquiring corporation from the resulting basis adjustment. Cost basis acquisitions are economically rational, therefore, only when the resulting tax is absorbed by operating losses.

The availability of operating losses, however, does not necessarily mean that the parties to the acquisition will benefit from a cost basis election. In the simple case of the acquisition of a nonsubsidiary corporation, the operating loss will survive a carryover basis acquisition and remain available to offset the taxable income of the acquiring corporation in the years following the acquisition. The loss itself thus constitutes a transferable asset of the target that is of value to the acquiring corporation. Therefore, in a carryover basis acquisition, the target will demand,

Prior to 1986, the principal explanation for that result would have been the General Utilities doctrine which had been statutorily extended to relieve virtually all target corporations from tax on a great portion of the unrealized appreciation in their assets. Under the 73-year regime of the General Utilities doctrine, the amount of tax imposed upon target corporations quite commonly was less than the present value of the tax benefits obtained by the acquiring corporation. The resulting discontinuity in the application of the corporate income tax created a major incentive to asset transfers and a substantial preference in favor of cost basis acquisitions. That rule, however, has now been repealed. At present, target corporations are nominally subject to full taxation with respect to transferred assets, and the General Utilities incentive for cost basis acquisitions no longer exists.

Also, throughout most of the history of the income tax, gain attributable to the disposition of capital assets was subject to a preferential, sometimes highly preferential, rate of tax. In 1986, capital gains derived by corporations were subject to a maximum rate of tax of 28%, IRC § 1201(a)(2), while the tax on ordinary income reached 46%. IRC § 11(b). Even in the absence of the General Utilities doctrine, the effective rate of tax imposed upon a target corporation might be substantially lowered if a major portion of the gain in its assets were eligible for this preferential rate. That preference, however, was also repealed in 1986 and thus, at present, does not provide any incentive for cost basis acquisitions.

The capital gains preference, however, cannot be entirely ignored. While absent from current law, its reinstatement, at least with respect to corporate stock, remains expected by most commentators. The broader reintroduction of that preference, in a form that would apply to a significant portion of the assets of typical target corporations, would, of course, require a reevaluation of the analysis that follows in the text. However, the same conclusion would likely be reached. See note 71 and accompanying text.

Under § 172(a) through (d), the net losses from the conduct of a business can be carried over and deducted against the income of the taxpayer in the three prior and 15 subsequent years. The purpose of the operating loss deduction is to mitigate the harshness of annual accounting on taxpayers having uneven flows of income and expense. Absent these provisions, such a taxpayer could be taxed on its income in profitable years, but, could obtain no benefits from losses in unprofitable years.

Under § 1.1502-21 of the regulations, the consolidated operating losses of members of the group are generally available to offset the consolidated income of the group.
and the acquiring corporation be willing to extend, additional compensation for that loss. That asset, however, possesses a unique quality. While it may be purchased and used by the acquiring corporation in a carryover basis acquisition, the asset will be destroyed if a cost basis election is made. The presence of this unique asset thus complicates the parties' choices.

If the parties elect a carryover basis acquisition, the operating loss survives the transaction and generates a stream of tax deductions to the acquiring corporation. Accordingly, the transferable loss will result in an increase in the purchase price received by the target corporation by an amount determined by the value of that loss to the acquiring corporation. That value is a function of the amount of the loss and the rate at which the loss can be applied to offset the otherwise taxable income of the acquiring corporation. The faster the loss can be used, the greater its present value.

On the other hand, if the parties elect cost basis treatment, the acquiring corporation will obtain an increase in the tax basis for the target assets, but does not receive its operating losses. Like the operating loss, however, that increase in tax basis will produce a stream of deductions that are of similar value to the acquiring corporation. Accordingly, in a cost basis acquisition, the purchase price received by the target will be increased by an amount determined by that value.\textsuperscript{58} However, in contrast to a carryover basis acquisition, the entire amount of the increase in purchase price paid in a cost basis acquisition may not generate net proceeds to the target corporation because cost basis acquisitions are subject to tax at the corporate level. While that tax may be offset by the target's operating losses, any remaining tax payable will diminish the net proceeds of the transaction.

Since the parties will prefer the form of acquisition that will generate the greatest net after-tax proceeds, a cost basis acquisition will be elected only if the value of the basis increase to the acquiring corporation reduced by the explicit tax imposed upon the target corporation exceeds the value of the operating losses to the acquiring corporation.

\textsuperscript{58} That purchase of tax deductions through the purchase of basis will in all likelihood be at quite a bargain price. Returning to the illustration in note 52, at a cost of $85, the acquiring corporation obtained assets with a tax basis of only $40. If the target has available to it losses that will completely absorb any gain on the transfer, the target will benefit from converting the transaction into a cost basis acquisition at a purchase price of $86. For the payment of that additional $1, the acquiring corporation obtains an increase in the basis of the assets of $46—from $40 to $86.
C. Essential Identity of Cost and Carryover Basis Treatment

Viewed in isolation, cost and carryover basis acquisitions appear as distinct and equally acceptable patterns of taxation. Examination of the considerations that would lead to the making of a cost basis election, however, suggests that in an elective regime they are neither. Regardless of the form of acquisition, the acquiring corporation obtains the physical assets of the business and the target obtains the purchase price in cash or another form of consideration. If the target in addition has a transferable operating loss, that asset, too, will be sold to the acquiring corporation for a payment in excess of the purchase price attributable to the physical assets. The sale either may be direct (as in the case of a carryover basis acquisition), or may be indirect. In a cost basis acquisition, the target corporation's operating losses are converted into an increase in tax basis which is then sold to the acquiring corporation in much the same manner as the operating losses would have been sold in a carryover basis acquisition. That tax basis, of course, generates tax deductions which will be available to offset the income of the acquiring corporation exactly as would an operating loss. Thus, in each instance, the acquiring corporation purchases the offsets against income that had been available to the target and the target is compensated for the transfer of those tax benefits by an increase in the purchase price received.

Moreover, in either form of transaction, the target corporation will, to some extent, bear the economic burden of the income tax attributable to the appreciation in its assets. As described above, in a carryover basis acquisition, the target will be forced to bear an implicit tax—imposed through a reduction in the purchase price—that represents the present value of that deferred tax liability to the acquiring corporation. And, in either form of acquisition, the target corporation will use its operating losses to reduce the tax imposed upon the transaction. In a taxable acquisition, the target can directly offset its taxable gain with its operating losses. In a carryover basis transaction, the implicit tax imposed upon the target is offset in a corresponding manner through the sale of the operating loss. To the extent that the loss will be available to the acquiring corporation, the purchase price will be increased. That increased price effectively reduces the implicit tax imposed upon the target. In substance, either form of acquisition is essentially taxable and either form of tax can be offset by the operating losses of the target.

Rather than constituting distinct patterns of taxation, cost and carryover basis acquisitions are merely alternative techniques for accomplishing essentially identical objectives. Making a cost basis election is simply one mechanism for selling the operating losses of the target to the acquir-
Without question, the complexity of the rules governing corporate acquisitions is greatly increased by the existence of alternative patterns of taxation. Even if both resulting tax burdens were acceptable as a matter of sound income tax policy, it should seriously be questioned whether that added complexity is justifiable when its primary function is only to provide alternative mechanisms for transferring operating losses. Whatever value might be assigned to the planning flexibility the dual mechanisms create would seem vastly outweighed by the costs of the provisions. Indeed, the only evident justification for such a statutory scheme would be the historic inability to select and impose a uniform system for taxing corporate acquisitions.

D. Cost Basis Election as a Tax Subsidy

The tax burdens produced by cost and carryover basis treatments, however, are not equally acceptable. To the contrary, in an elective system for taxing acquisitions, the cost basis election results in an improper reduction of the corporate income tax. A cost basis election becomes advantageous only when it creates a value for operating losses as a result of an acquisition that is greater than the value of those losses to the continuing business of the target. That value constitutes a tax subsidy of acquisitive transactions that violates sound congressional income tax policy.

A carryover basis pattern of taxing an acquisition should produce a tax burden on the transferred business in the hands of the acquiring corporation that replicates the burden that would have been imposed upon the target corporation in the absence of the acquisition. No income tax is accelerated and the tax attributes of the target corporation survive. Under prior law, that equation was frequently disturbed by the ability of acquiring corporations to use operating losses at a faster rate than could the target corporation from which they were inherited. Since the operating loss thereby became more valuable to the acquiring corporation than it was to the target, the loss itself provided an incentive to the acquisition.

In a recent revision of § 382, Congress addressed the distortion of normal market forces created by the favorable treatment of operating losses in the hands of acquiring corporations. The revised section was

59 Sophisticated students of this area are fully aware of this net effect of a cost basis election. See Yin, Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986, 42 Tax L. Rev. 575, 673 (1987) (election permits "freshening up the [target] losses").

designed expressly to limit the value of transferred operating losses to the value the loss had in the hands of the target corporation. That equivalence is sought by not allowing the acquiring corporation in any year to use an amount of target losses in excess of an amount equal to a reasonable rate of return on the value of the target assets.\textsuperscript{61} Since that limitation approximates the maximum amount of income that the target itself might generate with its own assets, the operating losses cannot be used by the acquiring corporation at a faster rate than they could be used by the target, and thus, the losses will not have a greater value to the acquiring corporation than they did to the target.\textsuperscript{62} Under current law, therefore, the treatment of transferred losses under a carryover basis system in the hands of the acquiring corporation also replicates the treatment of those losses in the hands of the target.

As explored above, cost basis treatment will only be elected when it results in a greater after-tax economic benefit to the parties to the acquisition than would carryover basis treatment. Since the tax burden of a carryover basis pattern of taxing an acquisition reproduces the tax burden that would have been imposed upon the target corporation in the absence of an acquisition, it necessarily follows that electing taxable, cost basis treatment produces a reduction in the corporate income tax relative to that level of taxation.

To ensure that business combinations are pursued for reasons that have economic justification, the taxing system ought not to provide a tax incentive to corporation acquisitions. Under current law, that principle of tax neutrality between continuing and acquired businesses is not a mere abstract ideal; rather, it has become a firmly established congressional policy. The repeal of the \textit{General Utilities} doctrine, the revision of \S~382, and other related legislation\textsuperscript{63} all reflect the entirely proper ascension of that policy of neutrality.

In an elective system for taxing corporation acquisitions, the cost basis election plainly violates that congressional policy. That pattern of taxation enhances the value of tax attributes in the course of an acquisition relative to the value those attributes otherwise would possess had the acquisition not occurred. The value so created constitutes a tax subsidy for those acquisitions for which a cost basis election produces a favorable result. Accordingly, the existence of the cost basis alternative improperly reduces the burden of the corporate income tax and serves as an incentive to acquisitive corporate behavior.

\textsuperscript{61} IRC \S~382(b).


\textsuperscript{63} That policy most clearly underlies the repeal of the \textit{General Utilities} doctrine and the revision of \S~382. It also is partly responsible for the adoption of \S~7704 which taxes publicly traded partnerships in the same way as the corporations they resemble.
The source of that subsidy can be seen from examining more closely the conditions under which a cost basis election can create a value for operating losses in the course of an acquisition that is greater than the value of those losses to a continuing business. Expressed symbolically, a cost basis acquisition will be elected only when the value of the basis increase to the acquiring corporation (the present value of $Br$, where $r$ equals the marginal rate of tax) reduced by the explicit tax imposed upon the target ($(B-L)r$, since the gain must equal the basis increase) exceeds the value of the operating loss to the acquiring corporation (the present value of $Lr$). Thus, a cost basis election will be made if:

$$p.v. \, Br - (B - L)r > p.v. \, Lr$$

or

$$p.v. \, Br - p.v. \, Lr > Br - Lr$$

or

$$p.v. \, B - p.v. \, L > B - L$$

The present value of $B$, the basis increase, will inevitably be smaller than the nominal value of $B$. Thus, in every possible combination of relationships between the size of the operating loss and the basis increase, a cost basis election will be rational only if the present value of the operating losses to the continuing business of the acquiring corporation is disproportionately reduced relative to the present value of the basis increase. That reduction in present value of the operating loss occurs when the period of time over which the loss can be deducted is appreciably longer than the period over which the basis increase can be depreciated. The reason that an operating loss would only be available to the acquiring corporation at a rate so much slower than the rate at which basis may be used is that the tax law itself imposes legal limitations on the use of losses by continuing businesses that do not apply to the tax benefits received in cost basis acquisitions. The principal such limitations are of two quite different sorts: § 382 and the doctrine of realization.

The effect of the revised § 382, of course, is to reduce, perhaps materially, the value of the losses of a target corporation to a profitable acquiring corporation. On the other hand, the ability of a profitable acquiring corporation to depreciate or otherwise benefit from the basis increase received in a cost basis acquisition is not subject to any similar limitation. Accordingly, the principal reason that the losses available in a carryover basis acquisition would have a value to the acquiring corporation less than the basis adjustment available in a cost basis acquisition is the limitation of § 382 on the ability of the acquiring corporation to use those losses.\(^{64}\)

\(^{64}\) Of course, either the target or the acquiring corporation could apply the target loss against gain realized on the disposition of business assets. See IRC § 382(h)(1)(A). However, to benefit from that use of the loss, the taxpayer would have to actually dispose of the appreciated asset.
The § 382 limitation on the use of target losses is amplified by a second legal restriction on the use of operating losses. While the period of time over which such losses can be used has been generously extended, time limitations remain. Thus, in general, losses unused for 15 years following the accrual of the original deduction expire.\(^{65}\) That limitation too is evaded by converting the loss to a basis increase.

Finally, the losses may be of little value to the acquiring corporation because the loss is unrealized and is inherent in an asset that the acquiring corporation intends to retain. To a continuing corporation or in a carryover basis transaction, those potential losses will be of no value whatsoever.\(^{66}\) Even if the loss is subsequently realized, the value of that loss will have been greatly diminished by the deferral of its tax benefit. The making of a cost basis election, however, creates a taxable event pursuant to which the otherwise unrealized loss may be recognized and used to offset the tax on the appreciation in other of the target assets.

The effect of a cost basis election, therefore, is to create a value in the course of an acquisition for the operating and unrealized losses of the target corporation that those losses would not otherwise have to the continuing business of either the target or the acquiring corporation. That value is created because the cost basis election permits taxpayers to avoid sound legal restrictions\(^{67}\) on the use of both realized and unrealized losses. The acceleration of the tax benefit of those losses represents a tax subsidy for corporate acquisitions that is inconsistent with the recently established congressional policy against providing tax incentives for such

\(^{65}\) IRC § 172(b)(1)(B).

\(^{66}\) Moreover, if such a built-in loss is realized after the acquisition, the loss becomes subject to the limitations of § 382. IRC § 382(h)(1)(B)(i). That limitation is similarly avoided by the cost basis election.

\(^{67}\) It might be asserted that § 382 is overly restrictive and that a cost basis election constitutes a reasonable loosening of those rules, rather than an inappropriate evasion. In a taxable, cost basis acquisition, the operating losses of the target can be used to wholly eliminate the explicit tax imposed upon the transaction. In a carryover basis acquisition, the sale of the operating loss functions to offset the implicit tax imposed upon the transaction in much the same manner. However, the ability of the target corporation to offset the implicit tax is limited by the value of the operating loss to the acquiring corporation. Thus, in contrast to cost basis acquisitions, the limitations on the value of the operating losses prevent offsetting the implicit tax by an amount determined by the nominal amount of the loss.

Thus, for example, if the nominal amount of the operating loss to be sold exceeds the unrealized appreciation in the target assets, in a taxable sale, the entire explicit tax could be offset. Absent restrictions on the ability of an acquiring corporation in a carryover basis acquisition to use that loss in the current year, the value of the loss would equal the implicit tax that would otherwise be imposed upon the target. Accordingly, the target could sell the loss for an amount that would completely offset the implicit tax. That result, however, is now barred by § 382.

Under the mandatory carryover basis proposal made here, the problem of even handed treatment of cost and carryover basis acquisitions evaporates and the limitations of § 382, which appear necessary to prevent tax motivated acquisitions, become unobjectionable.
transactions. The inescapable conclusion is that an elective system for taxing acquisitions should not be allowed.

E. Variations on the Theme

1. Consolidated Losses

In some circumstances, the losses available to the target to offset the gain triggered by a cost basis election could not be transferred to the acquiring corporation. Such a case could arise when the losses belonged to a consolidated group of corporations of which the target was a member, but the losses were not those of the target corporation itself. The effect of permitting a cost basis election in such a situation is in fact less defensible than in the case of nonsubsidiary acquisitions.

As in the case of nonsubsidiary acquisitions, it is inadequate to view the results of the making of a cost basis election as the imposition of a tax on the selling group which is properly offset by the operating losses of the group. As has been seen, that explicit tax will be incurred voluntarily only because it enables the target group to convert a portion of its operating loss into a more salable asset and thus obtain a higher purchase price in the transaction.

When the loss in question would be transferable to the acquiring corporation, the making of a cost basis election merely constitutes an alternative mechanism for accomplishing that transfer. The alternative may be objectionable because of its potential for avoiding legal restriction on the use of losses by acquiring corporation but the fact of the transfer of the operating loss is not itself objectionable. When the loss is not otherwise transferable, the legal restriction that is avoided by the making of a cost basis election is the very restriction on the transferability of the loss.

Since by hypothesis the loss is not directly related to the business being transferred, the operating loss of the target group ought not to accompany the asset transfer and would not do so in a carryover basis acquisition. However, the mechanism of the cost basis election enables the selling group to convert the nontransferable loss of the group into a transferable increase in basis that can be sold to the acquiring corporation.

If the cost basis election is an inappropriate mechanism for the sale of the operating losses of the business that generated the loss, the election is all the more inappropriate as a mechanism for the sale of operating losses not generated by the business being transferred. Indeed, since the loss is not directly related to the business being sold, the cost basis election amounts to little more than a mechanism for permitting the outright sale of the operating losses of the target group. Since such a sale is not al-

68 Reg. § 1.1502-79.
lowed independently of a corporate acquisition, there is no evident justifi-
cation for permitting that sale in connection with a transfer of a business
that did not generate the loss in question. Accordingly, the use of cost
basis elections for the purpose of avoiding restrictions upon the transfera-
bility of losses is also not appropriate.

2. Stock Acquisitions

The foregoing discussion has addressed corporate acquisitions in the
context of a buyer and seller jointly agreeing upon the treatment of the
acquisition and adjusting the purchase price accordingly. Under present
law, that context is most nearly represented by the choice in an asset
acquisition between taxable and reorganization treatment. Under pres-
ent law, however, an express cost basis election is provided following cer-
tain stock purchases.69

In the case of a stock acquisition, the parties will negotiate a price for
the assets to be purchased, corporate stock, that reflects the underlying
value of the physical assets and of the tax attributes of the target corpora-
tion. However, since both the benefits and burdens of making a cost ba-
sis election relate only to the acquiring corporation, the election ought
not to affect the shareholders of the target or the purchase price they
receive for their stock. Nevertheless, precisely the same factors that af-
fected the decision to elect cost basis treatment in an asset acquisition
will control the decision of the acquiring corporation following a stock
purchase. The acquiring corporation will make a cost basis election if
the value to it of the resulting increase in tax basis, reduced by the bur-
den of the accompanying tax liability, will exceed the value of the operat-
ning losses of the target.70 As before, that comparison of values will be
determined by the relative rates at which the acquiring corporation will
be able to use the tax deductions attributable to the basis increase or the
operating loss, respectively. And, as before, the rate at which the operat-
ing loss can be used is limited by the operation of § 382 and by the pres-
ence of unrealized losses.

As a result, the function of making a cost basis election in the context
of a stock acquisition is identical to its function in an asset acquisition.
The objections to that election developed above, therefore, apply with
equal force to the stock acquisition variation.71

69 IRC § 338(g).

70 The gain realized upon the making of a § 338 election cannot be offset by the losses of the
consolidated group of which the acquiring corporation is a member. IRC § 338(h)(9).

71 Either at present or in the future, a cost basis election might be desired because the bur-
den of the tax to the target was reduced by a preference or allowance other than operating loss
carryovers. In particular, if a preferential rate of tax on capital gains were reintroduced, the
present value of the tax benefits of a cost basis election might for that reason exceed the result-
ing tax burden. However, in an elective system for taxing acquisitions, the propriety of al-
For simplicity of illustration, this article has addressed expressly elective treatment at the corporate level that is presently provided by § 338 and would be extended under the proposals of the American Law Institute. However, the conclusion that elective taxation of acquisitions should not be allowed is not so limited. If the making of a cost basis election constitutes, in the current tax environment, an impermissible avoidance of sound legal restrictions on the ability to market operating and built-in losses, then all such elections ought to be prohibited, regardless of the form the election takes. Whether a cost basis acquisition is elected by filing a document or making an immaterial change in the form of the transaction is of no significance. Thus, the argument here that expressly elective treatment ought not be extended to the parties does not constitute an endorsement of the broad features of the existing rules. Rather, the rejection of that express election necessarily entails a rejection of the transactional election contained in current law.

Transactional elections, and the arbitrary definitions that produce them, are objectionable for a second reason; one that is nearly the reverse of the first. Rigid and complex definitions, not based upon an underlying financial reality, greatly increase the cost and difficulty of complying with the provisions of the taxing system and create harsh traps for the insufficiently cautious taxpayer. A stock acquisition, for example, that is intended to be a carryover basis acquisition by virtue of the reorganization provisions may be converted to a taxable acquisition at the shareholder level by the unintended receipt of a trivial cash consideration by one of the target shareholders. The acquisition may be made taxable at both the corporate and shareholder levels by the subsequent liquidation of the target into the acquiring corporation because of the nonrational distinctions in the reorganization definitions of stock and asset acquisitions.

The capital gains preference is designed to reduce the burden of the otherwise prevailing rate of tax for some reason Congress deems sufficient. In an elective system, a taxpayer would elect to be subject to capital gains taxation only if the resulting tax burden were lower than in a nonrecognition carryover basis transaction. The justification for such a use of the preference is difficult to find.

Using an analysis analogous to that in the text, it can be demonstrated that in this context, a cost basis election merely permits the target to sell its tax preferences to the acquiring corporation. Such a transaction plainly exceeds the legitimate bounds of the original grant of the preference to the target corporation and should not be allowed.

72 Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980).

73 For example, while prior ownership of stock in the target is no bar to a B reorganization, it is a bar to a C reorganization. See Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959). Accordingly, the prompt liquidation of the target following a good B reorganization under these circumstances could result in a bad C reorganization.
The presence of these arbitrary definitional provisions in the law may be of benefit to taxpayers desiring to make transactional elections—perhaps well after the consummation of the acquisition. Perhaps just as commonly, however, they can be injurious to taxpayers seeking in good faith to comply with the complex and irrational requirements of present law. The elimination of multiple definitional lines that do not reflect underlying economic differences would greatly simplify and rationalize these rules.

III. Towards Mandatory Treatment

The rejection of elective treatment of corporate acquisitions requires the adoption of a mandatory scheme of taxation. In principle, the optimum mandatory pattern might be either a single pattern of taxation applicable to all acquisitions, either a fully taxable cost basis, or a nonrecognition carryover basis pattern, or a pattern in which cost and carryover basis consequences were assigned to transactions that are clearly distinguishable on the basis of substantial nontax factors.

The most important criterion for selecting a pattern for taxing corporate acquisitions is that the resulting tax burden be logically and fairly related to the other broad features of the taxing system. A corporate acquisition is merely one form of economic behavior subject to the provisions of the tax laws, and the treatment of that form of activity ought not be disproportionate to other applications of the taxing system. In the context of a corporate acquisition, the development of a rational pattern of taxation requires reconciling the inherent inconsistencies between the taxation of stock and asset acquisitions created by the separate entity, double tax system. Further, the resulting system must successfully distinguish between transactions that are essentially dispositive, and thus taxable, and those that are essentially a nontaxable continuation of a business activity.

The decision to impose a mandatory pattern of taxation on all acquisitions, however, implies constraints beyond fairness and rationality. In sharp contrast to the transactional and express elections permitted under current law, a mandatory system requires a clear and defensible definition of the set of transactions that are to be subject to the mandatory system. Absent such a definition, the system will remain elective. It is therefore to the derivation of such a definition that attention should first be turned.

74 Other criteria can be imagined. If, for example, Congress desired to retard the pace of corporate acquisitions and determined to use the tax laws to promote that objective, a different scheme for taxing acquisitions would emerge. Such nontax policy criteria are not considered herein.
Statutory definitions normally do not, and ought not to, drive the selection of the pattern of taxing the activity defined. However, in the taxation of acquisitions, it will be seen that the potential for definition does have implications for the selection of the substantive tax rules. Thus, the process of defining the corporate acquisitions that are to be subject to the mandatory pattern of taxation also suggests what that pattern is to be.

A. Defining the Acquisition

The universe of possibly relevant corporate transactions is best viewed as a continuum stretching from the sale of a single asset to the sale of a single share of stock. At some point on that continuum, a sufficient quantity of assets, or of stock, has been transferred for the transaction to become recognizable as an acquisition. That acquisitive transaction, however, may only be faintly distinguishable from the adjoining, nonacquisitive point on the continuum. Moreover, under our separate entity, double tax system, there are points on that continuum that are unavoidably carryover basis transactions—minor sales of stock—and points that are unavoidably cost basis transactions—the sale of a single asset. Accordingly, regardless of how an acquisition is defined, the definition will encompass a range of transactions on a continuum that is adjoined on one side by a cost basis transaction and on the other by a carryover basis transaction. The process of defining an acquisition, therefore, is one of drawing one or more definitional lines between cost and carryover basis acquisitions.

To implement a mandatory system of taxing corporate acquisitions, the definitional line that is drawn must reflect, to the maximum extent possible, an underlying economic distinction. Unless all economically similar transactions are subject to the same pattern of taxation, the system will remain elective: Through making an economically insignificant alternation in the form of a transaction, taxpayers could achieve a different tax result. Accordingly, the adoption of a mandatory pattern of taxation requires identifying the most significant discontinuities in the continuum of corporate transactions. Only at that point, or points, can an enforceable line between cost and carryover transactions be drawn.

Deriving enforceable definitional lines is not only essential to the implementation of a mandatory system, it is essential to the fairness of that system. Under a mandatory pattern of taxation, transactions that are not meaningfully distinguishable ought not to be subject to different tax burdens. If a mandatory system were based upon an arbitrary definition of an acquisition, radically different income tax consequences would attach to economically insignificant differences in the form of the transaction. Such “cliff effect” provisions are intrinsically unfair if unavoidable, or they create transactional elections if they are susceptible to taxpayer ma-
nipulation. Thus, insisting upon a definition of a corporate acquisition based upon economic distinctions ensures, not only that the mandated tax will not be avoidable, but also that the tax will be fairly imposed.

1. **Distinguishing Asset and Stock Acquisitions**

At the very midpoint of the continuum of corporate transactions, the purchase of substantially all of the assets of a business meets the purchase of substantially of the stock in the corporate owner of the business. The formal distinction between these acquisitive techniques has seemed to suggest that a definitional line could be drawn at this point—as occurs under present law. In fact, however, the underlying economic distinctions between stock and asset acquisitions are far too trivial, and the choice between these forms too completely within the control of the parties, to provide a definitional basis for a mandatory system of taxing acquisitions.

At this intermediate point on the continuum, either form of transaction results in the complete transfer of the ownership of the business activities of the target and the resulting combination of the business of the target and the acquiring corporations. Thus, the end results of stock and asset acquisitions are essentially identical. Moreover, the parties to an acquisition have a high degree of freedom to select between stock and asset acquisitions. In practice, that choice is largely controlled by the relative convenience of the various available acquisition techniques and little of substance is affected by that decision. Under these circumstances, distinguishing among acquisitions depending upon whether stock or assets were purchased would be to create a transactional election of minimal burden. It is significant that those commentators who appear to favor a retention of the general pattern of present law with its distinction between stock and asset acquisition do so with ready acceptance of the transactional election that approach creates. In the context of elective treatment, the relatively minor nontax differences between stock and asset acquisitions might be thought sufficient to justify different patterns of taxation as occurs under present law. Even if that is so, however, those differences are clearly not sufficient to provide the definitional basis of a mandatory system, the purpose of which is to prevent transactional elections.

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75 See Senate Report on Subchapter C, note 9, at 45-46.
77 See Posin, Taxing Corporate Reorganizations: Purging Penelope's Web, 133 U. Pa. L. Rev. 1335, 1398 (1985); Shores, Letters to the Editor, Section 338—Do We Need a Change? A Response to Professor Yin, 37 Tax Notes 939 (Nov. 30, 1987).
The absence of a meaningful distinction between stock and asset acquisitions is forcefully evidenced by the blending of the forms of acquisitions that occurs in practice and the resulting difficulty in even factually distinguishing between stock and asset acquisitions. For example, not uncommonly, an acquisition may be commenced with the acquisition of a significant block of the stock of the target, perhaps a majority of outstanding shares, but completed as a merger or other form of asset transfer. Similarly, a simple stock acquisition followed by the prompt liquidation of the target corporation has always been treated under our taxing system as an asset acquisition. 78 On the other hand, the merger of the target corporation—essentially an asset transfer—with a subsidiary of the acquiring corporation will be treated as a stock acquisition if the target survives the merger. 79 Since, factually, the line between stock and asset acquisitions is scarcely perceptible, that line cannot have any relevance to a mandatory system of taxing corporate acquisitions.

For all of these reasons, it has historically been understood that stock and asset acquisitions merely represented different legal techniques for accomplishing the same economic result and that it was wholly inappropriate for the taxing system to prescribe materially different tax consequences to these different forms of the same transaction. One of the major achievements of the 1954 recodification was to minimize the tax consequences of the business choice between taxable asset and stock acquisitions. Similarly, the reorganization provisions of the Code have always extended comparable treatment to stock and asset acquisitions. The deviation under present law from this traditional treatment of acquisitions should be eliminated; stock and asset acquisitions should be made subject to the same pattern of taxation.

2. Stock Acquisitions

In our system of taxation, corporations are quite rigorously treated as entities wholly separate from their owners and income taxes are imposed at both the corporate and shareholder levels. In that world, the sale of a single share of stock has no corporate level implications whatsoever. It could be otherwise. In the taxation of partnerships, the sale of a partnership interest can result in basis adjustments at the entity level that are designed to ensure that the element of gain taxed at the partner level is not again subject to tax. 80 However, until conduit taxation replaces the separate entity, double tax system for corporations, the transfer of corporate stock is inherently a carryover basis transaction at the corporate

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80 IRC § 743.
level.\textsuperscript{81}

Simply because the transfer of one share of stock cannot have corporate level implications does not mean, of course, that some greater transfer could not have different income tax consequences. However, whether the acquisition of a specified percentage of the stock of a corporation could constitute a workable definition of a corporate acquisition for the purposes of implementing a mandatory system of taxation depends upon the underlying financial significance of whatever percentage is specified. If the definitional percentage lacks economic significance, taxpayers will be free to purchase a greater or lesser amount and thereby alter the tax consequences of the acquisition without economic sacrifice. As a result, the mandatory system could be avoided and taxpayers would retain a transctional election.

If the mandatory pattern of taxation selected was nonrecognition carryover basis, there would be no occasion to attempt a definition of a corporate acquisition in terms of stock transfers for the purpose of the corporate level tax. No acquisition of stock, regardless of the degree of ownership involved, would produce consequences at the corporate level any different from the sale of a single share of stock. Accordingly, an inquiry into the potential for defining an acquisition by reference to stock transfers is relevant only if a cost basis pattern of taxation is to be mandated.

Corporate acquisitions have traditionally been defined in terms of the acquisition or possession of a specified level, typically 80\%, of the stock of the target corporation.\textsuperscript{82} However, even in an elective system of taxation, stock based definitions are not satisfactory because of the almost infinite variety of acquisitive forms. In the mandatory system proposed here, such a definition of a corporate acquisition would be entirely unworkable. There are three principal types of difficulties in attempting to define acquisitions in terms of stock transfers.

\textsuperscript{81} It has generally been assumed, at least until recently, that the transaction costs of implementing such a conduit tax system for large, publicly traded entities would be prohibitive. The very form of business organization and the needs of the capital markets seemed to require the application of the separate entity approach to at least large corporations. Some doubt may have been cast upon that time honored assumption by the quite recent, but apparently brief, history of publicly traded partnerships. See IRC § 7704. Evidently, in some circumstances the benefits from avoiding the corporate level tax are sufficiently large to outweigh the cost and complexity of conduit taxation. Nevertheless, while perhaps tolerable, the conduit system of taxing partnerships is enormously unwieldy when applied to widely held entities in which the ownership interests change hands with a high degree of frequency. Even if such a system could be imposed upon all corporations, the inefficiency and inconvenience of such an approach should preclude the effort. Thus, it seems axiomatic that the sale of a single share of stock, at least in public corporations, cannot have corporate level consequences.

\textsuperscript{82} See IRC §§ 368(a)(1)(B), (a)(1)(C) (reorganization), 338(d)(3) (taxable stock purchase).
a. Complex Corporate Structures

The ownership of a corporation can be divided among a variety of classes of stock bearing different voting and economic interests. Thus, the definition of the level of stock ownership required for an acquisition must address both of these factors. Present law is not consistent in that effort and the range of approaches demonstrates the perhaps surprising difficulty of the task.

The problem can be illustrated with the simple case of a corporation having outstanding an equal number of shares of each of two classes of common stock, one voting and one nonvoting, but otherwise identical. For the illustration, assume that the required level of ownership change for an acquisition to have occurred is 67%. If the definition addresses just voting power, it would be possible for the acquiring corporation to own 83% of the economic interest in the target without producing an acquisition by acquiring all the nonvoting stock and 66% of the voting. On the other hand, an acquisition might occur, notwithstanding that the acquiring corporation owned only 34% of the economic interests in the corporation, if it acquired 67% of just the voting stock.

If the definition addressed the total value of all shares, it would be possible for the acquiring corporation to hold 100% of the voting power and 66% of the economic interest in the target without creating an acquisition. However, an acquisition might occur, although the acquiring corporation held only 34% of the voting power in the target, if it owned all of the nonvoting stock. Further, if the definition separately addressed both voting power and the value (or number) of nonvoting shares and required obtaining 67% of each, the acquiring corporation could own 100% of the voting power and 83% of the economic interests in the target without causing an acquisition to occur. In each instance, the line so drawn between acquisition and nonacquisition transactions would be wholly arbitrary for there would be no economically meaningful distinction between transactions that just exceeded or just fell short of that definition. Each definition would be under-inclusive and most would also be over-inclusive. Accordingly, each definition would permit a transactional election.

Moreover, were this definitional problem to be surmounted, taxpayers could attack the result through more complex corporate structures. For example, the acquisition of only 51% of the target corporation might not result in an acquisition, but would result in complete control over the

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83 Compare § 368(c) (vote and number of nonvoting), with § 1504(a)(2) (vote and value of all), and § 304(c) (vote or value of all).

84 For an unsuccessful attempt to manipulate a definition of control geared to 50% ownership, see Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974).
subsidiaries of the target corporation. Similar techniques have greatly complicated the effort to tax currently income earned by controlled foreign corporations.\textsuperscript{85}

\textbf{b. Partial Ownership}

A stock based definition must, of course, specify the level of ownership required for an acquisition. However, the higher the level of required ownership specified, such as 80\%, the less meaningful the definition becomes. Since acquiring corporations may completely dominate subsidiaries through far lower levels of ownership, the acquiring corporation can obtain all meaningful rights of ownership in the target without precipitating an acquisition. Without doubt, the 80\% ownership commonly specified under current law lacks any underlying economic significance. Indeed, it is generally recognized that the high 80\% requirement of current law implements a transactional election.\textsuperscript{86}

On the other hand, the lower the level specified in the definition, the less appropriate it becomes to impose the income tax consequences of a cost basis acquisition. Under § 382, restrictions are imposed upon the ability to use operating losses when there has been only a 50\% change in the ownership of the loss corporation.\textsuperscript{87} However, that restriction is not designed to impair the value of the operating loss to the target corporation; rather, the limitation is designed to permit the use of the loss at a rate consistent with the ability of the target to use the loss prior to the change in ownership.\textsuperscript{88} To treat that level of ownership change as a cost basis acquisition would impose an unacceptably harsher penalty on the shareholders of the target: the operating loss would be destroyed and a corporate level tax imposed upon the entire appreciation in the assets of the target corporation. Equally, it would not seem appropriate to allow a full step up in the tax basis for the assets of the target merely because of a 50\% change in ownership. Presumably for that reason, a 50\% ownership test has historically been used to define corporate control in Code sections designed to bar various abuses,\textsuperscript{89} but the higher 80\% threshold has been employed to define an acquisition. Yet, the 80\% requirement clearly creates a transactional election.

These difficulties, which are inherent in any stock based definition of an acquisition, cannot be avoided by the imposition of a partial tax, con-

\textsuperscript{85} See IRC §§ 1296 through 1297. And see Jelsma, Understanding PFICs and QEFs, 14 Int'l Tax J. 317 (1988).
\textsuperscript{86} For the classic illustration, see Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956).
\textsuperscript{87} IRC § 382(g)(1).
\textsuperscript{88} See text accompanying notes 60-62.
\textsuperscript{89} See, e.g., IRC §§ 304, 368(a)(2)(H).
forming to the degree of ownership change, or a partial basis adjustment. The ultimate benefits and burdens of either full or partial tax consequences would fall equally on the acquiring corporation and upon the shareholders of the target who did not dispose of their stock.

A greater significance for whatever level of stock ownership is specified could be created by attaching other income tax consequences to that level of ownership. For example, the level specified might be identical to the ownership level required for the filing of consolidated income tax returns\(^90\) or for the complete exemption from tax for intercorporate dividends.\(^91\) To the extent that the significance of these unrelated tax consequences to an acquiring corporation approached the significance of the choice between a cost or carryover basis acquisition, the freedom to engage in a transactional election would be constrained. However, for acquiring corporations unconcerned by such functionally unrelated tax effects, the ability to elect would be unaffected. More importantly, taxpayers would be able to obtain the collateral consequences of ownership while avoiding a cost basis acquisition through multiple stage acquisitions.

c. Creeping Acquisitions

Stock acquisitions need not occur through a single transaction; the target stock may be acquired in a series of transactions extending over several years. A stock based definition of an acquisition must therefore either require that the acquisition of the specified level of ownership occur in a single step, or treat as an acquisition obtaining the specified level of ownership through a series of perhaps minor and unrelated acquisitions. Thus, the acquiring corporation may have purchased 65% of the target stock in 1980. Ten years later an additional 5% might be acquired. If such “creeping” acquisitions fell within the definition and the specified ownership level were 67%, the relatively minor, second stage purchase would result in a cost basis acquisition with a corporate level tax on the entire appreciation in the target assets and an adjustment to the basis of those assets. Historically, that consequence has never been thought appropriate; the tax consequences of that approach are too far-reaching for such a minor stock purchase. Rather, the tax system quite correctly has always required that stock acquisitions that could result in cost basis adjustments be made during a brief period of time, such as one year.\(^92\) Creeping acquisitions have only been recognized in carryover basis reorganization type acquisitions in which there are no corporate level

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\(^90\) A coordination presently contained in § 338(d)(3) which defines the required level of stock purchase with a cross-reference to § 1504(a)(2).

\(^91\) IRC § 243.

\(^92\) See § 338(h)(1) which continues the identical requirement of prior law.
consequences.\textsuperscript{93} Continuing that pattern of existing law would require that a corporate acquisition that resulted in cost basis treatment must occur in a single transaction.

The single transaction requirement, however, is not consistent with a mandatory pattern of taxation. Taxpayers wishing to avoid the consequences of an acquisition could, with relative ease, structure multiple stage acquisitions which, on the one hand, would avoid cost basis consequences and, on the other, would ultimately result in all other tax and nontax benefits of complete ownership.\textsuperscript{94}

Plainly, it is possible to define corporation acquisitions in terms of the transfer of possession of a defined level of stock ownership. However, that definition of an acquisition is not suitable in implementing a mandatory pattern of taxation in which the acquisition of that level of ownership would be treated as a cost basis acquisition. It is simply not possible to draw a meaningful, nonarbitrary line that distinguishes one level of stock acquisition from another. Thus, in a mandatory system, all stock acquisitions should be treated identically. Since the sale of a single share does not have corporate level consequences, it follows that no stock transfers should have corporate level consequences. Stock transfers in any quantity are inherently carryover basis transactions.

3. Asset Acquisitions

In contrast to the sale of stock in a corporation, the sale of a single asset by a corporation does have corporate level income tax consequences, but does not have immediate shareholder level implications. Moreover, the current imposition of an income tax on asset transfers in the ordinary course of business is essential to the very concept of a corporate income tax. Thus, asset transfers are inherently and unavoidably cost basis transactions.

\textsuperscript{93} See § 1.368-2(c) of the regulations.

\textsuperscript{94} Other definitional problems created by creeping acquisitions have plagued existing law and ought be avoided to the extent possible. For example, at present, the acquisition of 80\% of the stock of a target corporation may be treated as a reorganization even if the stock is not acquired at one time but rather in a series of transactions occurring over a one-year period. In that event, all of the tendering target shareholders would be entitled to nonrecognition treatment. Similarly, a reorganization will occur upon the acquisition of sufficient stock to produce the required 80\% control even if the acquiring corporation previously owned a block of stock, say 50\%, in the target. Of course, in that event, only the shareholders of the target who tendered their stock in the final acquisition are entitled to nonrecognition treatment. But, what should be the result if the acquiring corporation obtains all of the stock of the target pursuant to a single plan, but the acquisition occurs on two days separated by 18 months? Surprisingly perhaps, one court has held that the transaction did not constitute a reorganization and that no shareholder was entitled to nonrecognition treatment. American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968).
In theory, it is possible to conceive of a system in which all intercorporate asset transfers were carryover basis transactions. However, the effect of such a system would be to defer the application of the income tax until the asset left corporate solution, if ever. The result would be to extend a major subsidy to incorporated business, as compared to the currently taxed unincorporated business, and to subsidize corporations selling goods to other corporations, as compared to corporations selling to the public or providing services. None of that makes any sense at all and would be entirely unacceptable. To the contrary, the demands of an income tax system require that sales in the ordinary course of business be subject to immediate taxation. If all corporate acquisitions were treated as cost basis transactions, there thus would be no need to distinguish among types of asset transfers. However, if the selected mandatory pattern of taxation were carryover basis, it would be necessary to divide asset transfers between acquisitive and nonacquisitive transactions.

In contrast to the sale of a financial asset like stock, it is possible in principle to discriminate among sales of real assets in a manner that reflects a substantial underlying economic difference. The transfer of a bundle of assets either will or will not include all of the properties necessary to the conduct of an income producing enterprise. The transfer, that is, will either be of an existing business enterprise or of something less, the product of the business activity or a component of the business assets. That distinction between the transfer of an entire business and the transfer of something less has a substantial economic significance that reflects normal business practice and is well understood by the financial community. While borderline cases of course exist or can be manufactured, virtually all asset transfers quite clearly constitute either a recurring disposition by the business of a portion of its properties or a disposition of the business itself. Accordingly, a material discontinuity exists in the continuum of asset transfers that does not exist in stock acquisitions.

4. Proposed Definition and Taxation of an Acquisition

Because of the presence of an economically significant discontinuity in asset transfers, a basis exists for developing an enforceable definition of a corporate acquisition. In principle, it would be entirely feasible to treat the transfer of substantially all of the assets of an existing business venture as an acquisition subject to the pattern of taxation that Congress selects to impose on those transactions. Conversely, transfers of less, nonacquisitive transfers, would remain subject to the pattern of taxation normally imposed upon transactions occurring in the ordinary course of business.
Defining corporate acquisitions solely by reference to asset transfers amounting to the transfer of an entire business activity and not by reference to stock transfers requires treating all acquisitions as carryover basis transactions. The transfer of assets by a corporation consisting of less than a business activity would remain a fully taxable, cost basis transaction. However, the balance of the continuum of corporation transactions would universally be treated as carryover basis transactions at the corporate level. Thus, sales of stock, without regard to the proportion of outstanding stock involved, would not produce corporate level consequences and would be carryover basis transactions. Similarly, the transfer of a going business through a sale of assets, rather than a sale of stock, would be taxed in the same manner. Regardless of the character of the consideration received by the target corporation, the transfer would not be subject to tax at the corporate level and the acquiring corporation would assume the tax attributes of the target, including tax basis and loss carryovers.

a. Compatibility with Present Law

Defining corporate acquisitions in terms of the transfer of an entire business activity does not require the development of a new income tax concept. Existing, not uncommonly encountered provisions of the current Code governing transactions closely related to acquisitions extend favorable income tax consequences to the transfer or retention of a level of assets sufficient to constitute a business activity. In particular, § 355 of the Code permits the tax-free division of a single corporation, but only along lines that represent entire business activities. Using the line already drawn by § 355 to define transfers that are to be treated as acquisitions would permit incorporating the accumulated experience under that provision represented by a developed body of case law and regulatory

95 Permitting the nonrecognition receipt of cash also determines the treatment of the assumption of recourse liabilities of the target corporation regardless of whether the liabilities exceeded the basis of the target assets. The purchase price in a carryover basis acquisition should be adjusted to reflect the value of such assumed liabilities. However, the price would not be adjusted to reflect the amount of nonrecourse liabilities in excess of the value of the properties they encumber. Accordingly, the target would not incur an implicit tax attributable to that excess portion of the borrowing which it would never repay. Properly, the excess of a nonrecourse debt over the value of property transferred in an acquisition should be treated as taxable cancellation of indebtedness income and not gain from the sale of property entitled to nonrecognition. The decision in Commissioner v. Tufts, 461 U.S. 300 (1983), confuses that result. See Coven, Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept, 74 Calif. L. Rev. 41, 75-79 (1986).

96 IRC § 355(b). See also IRC § 302(e)(2) (safe harbor rule for partial liquidation).

definitions.\textsuperscript{98}

Whether the sale of a business would in fact constitute an acceptable basis for defining a corporation acquisition subject to a mandatory pattern of taxation depends upon the ease with which taxpayers could manipulate their transactions to avoid that definition. Under a mandatory carryover basis pattern of taxing acquisitions, the primary source of pressure on the definitional line can be anticipated from taxpayers seeking to fit within the mandatory scheme.\textsuperscript{99} If taxpayers were able to convert significant numbers of ordinary business transactions into carryover basis dispositions, the corporate income tax would be unduly deferred and its effect improperly diminished. The incentive for such attempts would be greatest in the transfer of property generating little, if any, cost recovery allowances; in that event, the purchase price would be relatively unaffected by the receipt of a carryover basis. Attempts, however, to treat portions of a business as a complete business activity factually would duplicate the efforts under current law to achieve a tax-free division of a business activity. Under present law, most of the pressure on the statutory definition has come from efforts by small, closely held businesses to segregate portions of a single business activity in various corporations under common ownership.\textsuperscript{100} Thus, that effort to exploit the definition of a corporate acquisition would directly face the existing state of the law under § 355 and the viable distinctions drawn by that provision.

Concededly, the proposed definitional line, under current law or in the future, can never achieve crystal clarity; taxpayers desiring to alter the consequences of their transaction would not be deprived of all possible avenues of manipulation. However, because of the accumulated experience under § 355 and similar provisions, the existing tax law does contain a developed and discernible line between the transfer of a bundle of assets that constitute a business and the transfer of something less. That line could be used to create a workable definition of a corporate acquisition. Moreover, upon reviewing the continuum of corporate transactions from the sale of a single asset to the sale of a single share of stock, only one discontinuity that could serve as the basis for an enforceable defini-

\textsuperscript{98} Prop. Reg. § 1.355-3.

\textsuperscript{99} Taxpayers may seek to avoid the mandatory scheme by dismembering a business activity and selling portions of the business in taxable transactions. For that strategy to be successful, however, the taxpayers would have to receive greater net proceeds from a series of taxable sales of portions of a going business, after the application of operating losses, than they would from a nontaxable, carryover basis disposition of the entire business. It seems unlikely that many taxpayers would benefit from such an approach. If not, there should be little pressure on a mandatory carryover basis scheme from taxpayers seeking to avoid its consequences.

By contrast, there would be considerable effort by taxpayers seeking to avoid a mandatory cost basis scheme. That a carryover basis approach will correspond to the desires of most taxpayers in the current tax environment will enhance the success of that approach.

\textsuperscript{100} See e.g., King v. Commissioner, 458 F.2d 245 (6th Cir. 1972).
tion of a corporate acquisition emerges. A distinction based upon the
transfer of an entire business activity is the definitional line that is, at the
very least, the most defensible in practice of all possible lines.

b. Shareholder Level Requirements

The proposed definition of a corporate acquisition does not include
any reference to the nature of the consideration received by the target
corporation or its shareholders or the extent to which the shareholders of
the target remain as shareholders of the acquiring corporation. Under a
mandatory system of taxing corporate acquisitions, the tax consequences
at the corporate level cannot be affected by shareholder level transac­tions. Were such a connection to exist, the corporate level tax would not
be mandatory, rather, it would vary as a function of the shareholder level
event. For example, continuing the requirement of present law that, in a
reorganization type asset acquisition, the consideration received by the
shareholders of the target must consist solely of stock of the acquiring
corporation (or its parent) would permit the parties to elect or avoid cost
basis treatment by the use of a nominal cash consideration.\textsuperscript{101}

Under current law, carryover basis treatment for asset acquisitions is
available only in a reorganization where the consideration received by
the shareholders of the target must consist of stock in the acquiring cor­poration.\textsuperscript{102} However, and somewhat inconsistently, carryover basis
treatment is always available following a stock acquisition, regardless of
the nature of the consideration. The proposal here is, in general effect, to
extend to asset transfers that comprise an entire business the carryover
basis treatment that presently extends to stock acquisitions. That paral­lel
treatment is entirely consistent with sound income tax policy. To the
extent that stock and asset transfers produce essentially identical eco­nomic results, differences in tax treatment are improper. Accordingly, it
is entirely appropriate to define carryover basis acquisitions without ref­ERENCE to the nature of the consideration paid by the acquiring corpora­tion. In this respect, the proposal here is similar to the proposals of the
American Law Institute pursuant to which the corporate level conse­quences of an acquisition would not depend upon the nature of the con­sideration received by the target shareholders.\textsuperscript{103}

\textsuperscript{101} The extent to which the treatment of the shareholders should depend upon the treatment
of the corporation is a separate question and is considered below.

568. See also text accompanying notes 69-77.

\textsuperscript{103} Subchapter C Project, note 9, at 167. Proposal D1 would allow nonrecognition treat­ment to any shareholder receiving stock in an acquiring corporation incident to an acquisition
without regard to the character of the consideration received by the other shareholders. Thus,
the proposal would dispense with the judicial continuity of the proprietary interest doctrine.
c. Neutrality of the Business Activity Test

The proposed definition line receives justification, not only from considerations of expediency, but also from considerations of tax principles. Defining corporate acquisitions in terms of asset transfers permits that definition to encompass the transfer of all economically identical business activities without regard to the legal technicalities of the form of ownership of those activities. Under such a definition, the transfer of an entire business would be treated as an acquisition regardless of whether that business activity was the sole activity of the target corporation, was one of several divisions operated by the target, or was owned by a subsidiary of the target parent. As a result, such a definition would possess a high degree of neutrality among forms of business organization.

By contrast, defining acquisitions in terms of stock transfers would, in the absence of an elaborate set of additional rules, be highly non-neutral across forms of business organization. Under such a definition, the disposition of an entire business activity would not be treated as an acquisition if that activity were conducted as a division, notwithstanding that the transfer of an identical bundle of assets would be treated as an acquisition if they were the only assets of the target. Worse, the transfer of those same assets would presumably be treated as an acquisition if the target held those assets in a wholly-owned subsidiary, rather than as a division—an economically irrelevant distinction. That result would be unsound. The transfer of a bundle of properties that constitutes a business activity, and might have been conducted as the entire activity of a corporation, ought to be treated as an acquisition and taxed in a manner consistent with all other transfers of comparable bundles of assets. A contrary rule places too high a premium upon otherwise unnecessary advance tax planning and encourages taxpayers to engage in pointless restructuring of their business organizations in anticipation of an acquisition.

Historically, asset acquisitions have been defined in terms of the acquisition of “substantially all” of the assets of the target corporation.\footnote{IRC § 368(a)(1)(C), (2)(D), and (2)(E)(i). See also Rev. Proc. 77-37, 1977-2 C.B. 568, 569.} That more restrictive requirement was adopted for the purpose of conforming the scope of an asset acquisition to the scope of a stock acquisition pursuant to which, of course, all assets would be acquired. Unfortunately, that definition imposed upon asset transfers the same irrational inconsistencies that infect the definition of a stock acquisition. In fact, that aspect of the definition of an asset acquisition has been responsible for much of the irrationality in the taxation of reorganizations. For example, the division of a single corporation in anticipation of an acquisition has barred reorganization treatment for a subsequent asset
acquisition because the substantially all test was applied to the historic assets of the target, although no principle of tax policy would be offended by permitting reorganization treatment of the acquisition of one of the corporations resulting from the division. Without question, the substantially all assets requirement of present law is a source of irrationality that ought to be eliminated in any reform of these provisions and would not provide a satisfactory basis for defining an acquisition.

5. Enforcement: Scope of the Definition

If assets, once incorporated, could never leave corporate solution, enforcing a mandatory carryover basis scheme, given a workable definition of a corporate acquisition, would not be troublesome. The problem of enforcement, however, is greatly complicated by the potential for blending the corporate and shareholder levels of taxation. Carryover basis treatment of intercorporate transactions is an entirely acceptable result because the liability for the corporate tax is merely deferred in the transferred basis. However, the sale of assets to an unincorporated purchaser cannot preserve the corporate tax. Even if the purchaser assumed a carryover basis, a subsequent sale would only be subject to a single level of the individual income tax.

It might therefore appear that sales to noncorporate purchasers could not be included within the scope of a carryover basis system for taxing acquisitions. If that is so, great difficulties would be created for implementing a mandatory scheme. Because sales to different classes of purchasers would have different income tax consequences, the complexity of the approach, both in principle and in practice, would be enormously increased. Moreover, since an unincorporated purchaser can incorporate, serious step transaction problems would hamper the enforcement of a mandatory system. At the worst, taxpayers would regain a transactional election through the ability to use an unincorporated intermediary between the target and the acquiring corporation. Indeed, the entire system for taxing acquisitions could be returned to its origins. The 1954 codification of the General Utilities doctrine evolved from taxpayer attempts to avoid the corporate level tax on intercorporate sales by washing the assets to be transferred through the shareholders of the target corporation. These difficulties for mandatory carryover basis, however, can be avoided.


106 The Internal Revenue Service may have come to a similar conclusion. In Rev. Rul. 88-48, 1988-1 C.B. 117, the Service ruled that the prior sale of 50% of the assets of the target did not bar a C reorganization if the acquiring corporation also obtained the proceeds of the sale.
From the perspective of the target corporation, the identity of the purchaser of its assets is wholly immaterial. If it is improper to impose a corporate level tax upon the transfer of the ownership of a business, the impropriety is not relieved by a sale to a noncorporate purchaser. Under the historic General Utilities reconciliation, that proposition was fully implemented: The identity of the purchaser was irrelevant to the forgiving of the corporate level tax. It has been argued here that the consequence of the General Utilities doctrine to target corporations in the context of acquisitive transactions was sound. That conclusion is not affected by the presence of a noncorporate purchaser. Both principle and the requirements for enforcing a mandatory system require that the carryover basis system of taxation include acquisitions by noncorporate, as well as corporate, purchasers.

A carryover basis system of taxing acquisitions by noncorporate purchasers would not result in a greater reduction of the corporate income tax than would a carryover basis pattern of taxing acquisitions by corporate purchasers. As described above, in a corporate acquisition subject to a carryover basis system of taxation, the explicit corporate tax upon the target corporation is replaced by an implicit tax in the form of a purchase price reduction. Depending upon how the parties to the acquisition share the tax savings produced by the deferral of the income tax, the net proceeds received by the target shareholders in a carryover basis acquisition should approximate the proceeds they would receive in a fully taxable, cost basis acquisition. Under prior law, that result was not achieved because the cost basis obtained by the acquiring corporation eliminated the need for a purchase price adjustment, and thus, eliminated the implicit tax on the target. In a carryover basis acquisition as proposed here, however, that implicit tax will be imposed.

The amount of the implicit tax that must be imposed upon the target corporation in a carryover basis acquisition is a function of the rate of tax imposed upon the acquiring entity. That rate influences the level of the explicit tax imposed upon the acquiring entity and thus the size of the purchase price adjustment. If the rate of tax imposed upon an noncorporate purchaser is the same as the rate of tax imposed upon a corporate purchaser, the purchase price adjustment that each acquiring entity must make would be identical and thus the amount of the implicit tax would also be identical. Under these conditions, therefore, the target corporation would not avoid the consequential burden of the corporate tax through a sale to a noncorporate purchaser.

Historically, the maximum rates of tax imposed upon unincorporated businesses have exceeded the rates of tax imposed upon corporations. Under those conditions, of course, the implicit tax that a noncorporate purchaser would be forced to impose upon the target would exceed the
implicit tax produced by a sale to a corporate purchaser. At present, the maximum marginal rate of tax imposed upon corporations slightly exceeds the maximum marginal rate imposed upon individuals\textsuperscript{107} and unincorporated businesses. Whether that minor rate inversion is retained or the historic rate relationship is reimposed, from the perspective of the target corporation, sales to noncorporate purchasers do not result in an avoidance of the corporate tax.

When the acquiring entity is a corporation, a subsequent explicit tax will be imposed at the corporate level on the appreciation in the target assets that will not be imposed following a sale to an unincorporated purchaser. However, the absence of that corporate level tax is fully compensated by the individual level tax\textsuperscript{108} that results from carryover basis treatment of the noncorporate purchaser. By contrast, were sales to noncorporate purchasers taxable, cost basis acquisitions, a corporate level tax would be imposed at the time of the sale and no tax liability would be assumed by the noncorporate purchaser. In the proposed carryover basis treatment, no corporate level tax would be imposed on the target, but the deferred tax liability would be assumed by the noncorporate purchaser. In either case, the shareholders of the target will be fully subject to tax on the ultimate distribution of the proceeds of the sale, reduced by either the implicit or explicit tax imposed at the corporate level.

Narrowly viewed, treating an acquisition by a noncorporate purchaser as a carryover basis transaction results in a reduction of corporate tax collections. However, as long as the rate of tax payable by noncorporate entities approximates or exceeds the rate of tax payable by corporations, that reduction in the corporate tax is fully compensated by an increase in the individual level tax, without any other revenue losses. Since carryover basis treatment of noncorporate purchasers is important to preserving the mandatory feature of the proposed system for taxing acquisitions and does not result in a revenue or equitable sacrifice, the definition of a corporate acquisition subject to carryover basis taxation should include acquisitions by noncorporate purchasers.

That treatment of noncorporate purchasers would also control the taxation of distributions in kind. A distribution in kind to shareholders is a

\textsuperscript{107} Under § 1, the nominal maximum effective rate of tax is currently 28%. However, by virtue of a series of phased-out deductions and other allowances, most high income taxpayers will face marginal rates of tax that range from 33% to over 50%. See Coven, Congress as Indian-Giver: “Phasing-Out” Tax Allowances Under the Internal Revenue Code of 1986, 6 Va. Tax Rev. 505 (1987).

\textsuperscript{108} If a noncorporate purchaser was subject to a low rate of tax, or was tax exempt, the tax on the purchaser would not compensate for the failure to impose the corporate level tax on the disposition. That imperfection, however, is no different from the tax leakage generally created by low rate acquiring entities. See note 53 and accompanying text.
transaction having an underlying dual character. Constructively, a corporation is selling an asset to a purchaser that coincidentally happens to be its shareholder. At the same time, the corporation is making a distribution to its shareholders of the proceeds of that constructive sale.

Both aspects of the transactions are properly subject to tax in accord with their individual nature. Thus, under present law, the sale of the assets is a taxable transaction at the corporate level, while the receipt of the proceeds of the distribution is fully taxable at the shareholder level. If the proposal made here were adopted, the sale component of the distribution in kind would be subject to tax in the same manner as if the sale were to an unrelated purchaser. Thus, if the assets distributed consisted of a business activity, the transfer would be subject to a carryover basis pattern of taxation; no tax would be imposed at the corporate level and the distributee shareholders would assume a carryover basis in the transferred assets. Upon the distribution of the proceeds of the constructive sale, however, the shareholders would be fully subject to tax as under present law. 109

6. Politics and Simplification

Any mandatory pattern for taxing corporate acquisitions would result in enormous simplification of the taxing system. Under present law, acquisitions must be distinguished from nonacquisitive stock purchases on one side and from nonacquisitive asset transfers on the other. Moreover, reorganization-type carryover basis acquisitions must be distinguished from all other forms of acquisitions. Under any mandatory pattern, most of those arbitrary and scarcely enforceable lines would be abandoned.

Firstly, the entire complicated set of rules defining and taxing reorganizations would be entirely repealed. If a cost basis pattern were adopted, the reorganization provisions would be inconsistent with the pattern selected and would have to be eliminated. Conversely, if the carryover basis pattern suggested here were selected, the reorganization

109 While the taxation of distributions in kind does not present any additional conceptual hurdles, it does pose one practical problem. Because the sale of the corporate assets is constructive, the amount paid for the assets, and thus the amount of the taxable distribution, is not established by an actual transaction. It would not be appropriate to tax the shareholders on an amount equal to the market value of the distributed assets because those assets were constructively purchased in a carryover basis transaction which would result in a discount in the purchase price and thus in the amount of the distribution to the shareholders. In principle, the sales price for the assets and thus the amount of the distribution should equal the value of the distributed assets less the present value of the deferred tax liability assumed by the shareholders in the carryover basis acquisition. However, while we expect the parties to an acquisition to negotiate a value of the deferred liability, only an imprecise and speculative value can be assigned to such a liability.
rules would be entirely subsumed with the scope of the new definition of an acquisition and would be unnecessary.

That measure of simplification, however, would only be achieved if a mandatory pattern actually were adopted. While the practical possibility of enacting a rigorous carryover basis pattern of taxation is far from clear, the likelihood that a mandatory cost basis pattern of taxation would be adopted is virtually nonexistent. There are simply too many forms of corporate transactions, such as simple reincorporations,\(^\text{110}\) that present a highly appealing case for nonrecognition carryover basis treatment for the reorganization provisions to be wholly repealed. Absent that repeal, both cost and carryover basis acquisitions would continue to exist and there would not be a mandatory pattern of taxation. Rather, the existing line between cost and carryover basis acquisitions, at best, would merely have been somewhat rationalized. Accordingly, the only real possibility for substantially simplifying the taxation of corporate acquisitions is the adoption of a mandatory carryover basis pattern of taxation.

Secondly, under any mandatory system, at least for the purposes of the corporate level tax, only a single definitional line need be drawn. Under the proposal made here, there would be no occasion to define a corporate acquisition by reference to stock acquisitions for the purposes of universally applicable Code provisions,\(^\text{111}\) for stock transfers, regardless of their nature, would not have corporate level consequences. Rather, the only definition needed would be of the transfer of a sufficient bundle of assets to constitute a separate trade or business. The drawing of such a single definitional line would greatly simplify the taxing system. Since stock transfers are inherently carryover basis transactions and assets transfers are inherently cost basis transactions, the task of drawing one or more lines across the continuum of transactions is unavoidable. However, the fewer the lines that are drawn, the less complex and less arbitrary will be the statutory pattern. Distinguishing between asset transfers involving an entire business activity and those that do not provides a single definitional line between cost and carryover basis acquisitions and thus would contribute the maximum possible degree of simplification. Even were it assumed that the use of that definition to define an acquisition would increase the pressure on that definition, that cost would be more than offset by the simplification resulting from the use of a single definitional line.

\(^{110}\) It would be unsound, for example, to impose a tax on the mere conversion of a New Jersey corporation into a Delaware corporation through the mechanism of a statutory merger with no material change in business or stockholders.

\(^{111}\) However, it might remain necessary to define acquisition-type transactions accomplished by stock transfers for other purposes of the Code. For example, the loss limiting rules of § 382 are triggered by a 50% change in the beneficial ownership of the loss corporation.
IV. Restoring the General Utilities Compromise

That a mandatory carryover basis pattern for taxing a corporate acquisition is required by the only defensible definition of an acquisition does not, of course, alone demonstrate that such a pattern would be appropriate in principle. However, carryover basis is in fact the pattern of taxation that is most consistent with the broad structure of the taxing system. Deferring the corporate level tax at the time the ownership of a business changes would restore the historic burden of taxation imposed upon corporate acquisitions that was reflected in the General Utilities doctrine.

A. Historic Reconciliation

The fundamental logic of the separate entity concept is that changes in the ownership of incorporated business through sales of stock do not have income tax consequences at the corporate level. On the other hand, the demands of the corporate income tax require that sales of assets be subject to immediate tax at the corporate level. When all of the assets of a corporation are transferred, the demands of the corporate income tax conflict with the demands of the separate entity system of which the tax is a part. Since the choice of an asset, rather than a stock, transfer is almost entirely volitional and the distinction between these formats is largely formal, imposing differing burdens of taxation based upon that distinction is manifestly arbitrary and an undesirable elevation of form over substance in an area of the law having substantial importance. Accordingly, if the separate entity system bars a corporate level tax because of a change in the ownership of the business through a stock sale, a change in ownership occasioned by an asset sale ought not to be taxed differently. However, the demands of the corporate tax appear to require precisely that different treatment.

Historically, that internal conflict in the taxing system has been reconciled by excusing from the corporate level tax, in all forms of acquisitions, the gain in assets that are being retained in the business which would not have been recognized in the absence of the transfer of the business. The demands of the corporate income tax unavoidably required that income that would be recognized in the ordinary course of business had the ownership of the business not changed be fully subject to tax. However, the logic of the tax did not require that the separate corporate entity be subject to tax on the appreciation in the assets that were retained in the business merely because the ownership of that business changed. Since no such tax would have been imposed upon a change in ownership through a sale of stock, no such tax need be imposed upon a change in ownership accomplished by a sale of assets. As a result, the logic of the separate entity concept was given effect upon
changes of business ownership through asset transfers and was reconciled with the legitimate demands of the corporate tax.

This judicially created and refined reconciliation of stock and asset acquisitions, however, was overbroad in two critical respects. The doctrine did not distinguish between the severance of an asset from the business and the change in the ownership of the business. While the significant impact of the *General Utilities* doctrine was upon corporate acquisitions, the doctrine applied to a far greater range of transactions. Indeed, as originally developed, the doctrine excused from the corporate level tax the appreciation in any asset distributed to shareholders from either a liquidating or a continuing business. That aspect of the *General Utilities* doctrine opened massive opportunities for taxpayer abuse which were widely exploited.\(^{112}\)

Secondly, the development of the doctrine, consistently with the general development of the taxing system, was oriented towards taxpayers, not transactions. Thus, the exemption from the corporate level tax extended to sellers was not accompanied by a correlative adjustment to the purchaser. Rather, the purchaser of an asset was unaffected by the application of the *General Utilities* doctrine to the seller and thus obtained a cost basis for the transferred asset, notwithstanding that the seller has been excused from tax. The result was a major erosion of the integrity of the corporate tax and an undesirable subsidy of acquisitive transactions.

Because the acquiring corporation obtained a cost basis in the transferred assets, it was not required to assume the deferred tax liability of the target corporation. Accordingly, the purchase price for the target assets was not discounted by the present value of the tax liability, as would occur in a carryover basis acquisition. The absence of that discount meant, of course, that the target corporation was not subjected to an implicit tax on the transfer. The failure of the *General Utilities* doctrine under prior law was not the failure to impose an explicit tax upon the target corporation. Rather, the inadequacy of prior law was the failure to impose an explicit tax upon the acquiring corporation which, in turn, permitted the target corporation to escape the imposition of an implicit tax through an adjustment to the purchase price.

These twin defects in the *General Utilities* doctrine led to its complete demise. Rather than distinguish among levels of asset transfers, all became taxable. And, rather than impose a carryover basis upon the acquiring corporation, a full corporate level tax was imposed upon the target. As a result, the historic compromise between the carryover basis demands of the separate entity approach and the cost basis demands of

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\(^{112}\) See, e.g., *Bush Bros. & Co. v. Commissioner*, 668 F.2d 252 (6th Cir. 1982). The *General Utilities* case itself involved a dividend distribution from a continuing corporation.
the corporate tax was eliminated from the taxing system. That was error.

B. Propriety of the Single Tax Solution

In evaluating the propriety of imposing a corporate level tax at the time of a change in ownership of a business, the ultimate issue, of course, is one of realization of income. In an ongoing business, a tax is not periodically imposed on the appreciation in the value of the assets of the business; nor is the corporate taxpayer free to periodically purge the tax attributes of an ongoing business and obtain an increase in the basis for the business properties by volunteering a tax on their appreciation. The issue presented is whether those results should be different when there has been an antecedent change in the ownership of the incorporated business. If the failure to impose a corporate level tax at the time of an acquisitions would result in an undue under-taxation of any party to the transaction, the tax, of course, must be imposed. However, if explicit taxation is unnecessary to the integrity of the corporate or shareholder level tax, there would be no justification for altering the normal pattern of taxing incorporated business.

Clearly enough, the imposition of that tax is not required to protect the integrity of the corporate income tax; that protection is fully provided by the carryover of tax attributes to the acquiring corporation. Accordingly, the justification for the imposition of the tax must be found in some requirement of the shareholder level tax. Thus, the issue of realization at the corporate level must be resolved by determining whether the integrity of the shareholder level tax would be impaired by the absence of a corporate level levy. Significantly, therefore, regardless of whether the change in ownership of the business is accomplished by a stock or asset transfer, any justification for the imposition of a corporate level tax would necessarily be inconsistent with the separate entity concept.

Whether the transfer of the ownership of a business is accomplished by an asset or a stock transfer, the purchase price will be determined by the asset value and earning potential of the business itself, taking into account the liabilities of the business assumed by the acquiring corporation. In a carryover basis acquisition, one of those liabilities is the deferred income tax liability of the target attributable to the appreciation in the value of its assets. As described above, given a perfectly functioning marketplace, in an asset acquisition, the target corporation and its shareholders will be forced to bear an implicit tax on the appreciation in the value of the target assets through a purchase price adjustment for the tax liability assumed by the acquiring corporation. Since no greater price should be paid for the business in a stock acquisition, the shareholders would be required to bear a comparable burden regardless of the form of the trans-
action. If that occurs, the integrity of the shareholder level tax, to the extent it is dependent upon taxation at the corporate level tax, will be preserved by a carryover basis pattern of taxation and the imposition of an explicit corporate level tax will be unnecessary.

The commentators who have endorsed a cost basis approach to corporation acquisitions appear to have done so primarily in the belief that the marketplace for corporation acquisitions is far from perfect, and that in fact, the target corporation may not be required to bear an appropriately burdensome implicit tax.\textsuperscript{113} While undoubtedly true, that perception merely discloses a private failure of negotiation that has no significance in the fashioning of tax rules.

If the parties to an acquisition do not accurately value the tax liability assumed by the acquiring corporation, the purchase price for the target corporation will be erroneous. If the liability is largely ignored, as seems to be feared, the price will be unduly inflated. As a result, the target shareholders will derive a greater gain than would occur in a sale to a more careful buyer, but will be taxed on that greater amount. And, since the acquiring corporation will have paid for a value it did not receive, its shareholders will ultimately be entitled to an offsetting loss or reduction in gain. The net effect of the transaction will be a taxable shift of value from the buyer to the seller and an acceleration of the tax collection process to the extent of the excessive price. Under these circumstances, there will not only be no revenue loss from ignoring the tax liabilities, there will be a revenue gain through acceleration.\textsuperscript{114} In the interim, of course, the corporate level tax will be unaffected by the error for the amount of that tax will be perfectly preserved in the carryover basis.

Many of the liabilities of the target corporation assumed in the acquisition will be difficult to value. If the parties so desire, they may ignore those liabilities altogether in establishing a purchase price for the business. Should they proceed in such a marginally rational manner, the acquiring corporation will overpay for the business and the target corporation will be overpaid for its assets. Such imperfections are more likely the rule than the exception in complex transactions, but have no implications for the taxing system. The improper valuation of an assumed tax liability does not present any different issue. The economic benefit obtained by the target, and the economic detriment suffered by the acquiring corporation, attributable to a faulty valuation of the assumed tax liability is of no different character than the consequences of any other miscalculation of the assets or liabilities of the target.

\textsuperscript{113} See Lewis, A Proposal for a Corporate Level Tax on Major Stock Sales, 37 Tax Notes 1041 (Dec. 7 1987).

\textsuperscript{114} Conversely, if the parties overvalue the tax liability, the seller will not be adequately compensated for its properties and the tax imposed upon the target shareholders will be correspondingly reduced.
The consequences of the erroneous valuation of a tax liability do not have any systematic effect upon the amount of tax imposed upon corporate acquisitions. While the error may result in a shift of value and tax liability between the parties to the transaction, the parties are in a position to protect themselves from the consequences of their error through more careful negotiations. There is no occasion to alter the rules of taxation applicable to all acquisitions in order to protect the careless or ill advised. Accordingly, there is no principled need for the imposition of a corporate level tax on the value of a transferred business.\(^{115}\)

Moreover, indisputably, the imposition of a corporate level tax upon a stock acquisition would be wholly inconsistent with the traditional understanding of the separate entity/double tax concept. Under that approach to corporate taxation, a corporate level tax is imposed as income is derived at the corporate level. Absent the immediate taxation of the shareholders on that income under some form of tax integration, that corporate tax is presumably necessary to prevent an undue deferral of any tax on the income so derived. A second tax, at the shareholder level, is imposed as the shareholder harvests the benefit from those corporate earnings, either through distributions or sales of stock. The gain derived by the shareholder on a sale of stock will, of course, reflect the value of unrealized appreciation in the assets of the corporation. Subjecting that gain to tax upon a sale of stock represents a voluntary acceleration of the shareholder's tax liability which, of course, is required by the shareholder level event. However, nothing in this double tax system suggests that this anticipation of gain by the shareholder should cause a similar acceleration of tax liability to the corporation. Rather, the corporate level tax continues to be imposed at the time that the corporation realizes its income under the normal accounting rules of the Code.

The enduring merit of the General Utilities doctrine lay in the recognition that, while imposing a corporate level tax following a stock acquisition was wholly inconsistent with the separate entity concept, excusing that tax following an asset acquisition was not wholly inconsistent with the integrity of the corporate income tax. Quite the contrary, continuing to defer the taxation of unrealized appreciation in the business assets seemed as appropriate following an asset transfer as it was following a stock transfer. Since the overall rationality of the system would be pro-

\(^{115}\) When the target corporation is closely held, there is a further reason for not imposing a corporate level tax at the time of an acquisition. Most closely held corporations do not pay a significant entity level tax, often because corporate profits are remitted to the owners of the business through techniques that permit income tax deductions for the amount distributed. See Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process, 8 Va. Tax Rev. 57 (1988). It would be perverse and unwarranted for the only occasion upon which a significant corporate level tax was imposed to be at the time of the disposition of the business.
moted by imposing comparable burdens of taxation on stock and asset acquisitions, logic demanded that the corporate level tax on asset acquisitions be excused, notwithstanding the insubstantial tension with the corporate income tax so created.

The broadest features of the taxing system are most compatible with the notion that a mere change in the ownership of a business, regardless of how accomplished, does not result in a corporate level tax upon the appreciation in the value of the assets that are retained in that business. That result should be secured by returning to the General Utilities compromise that has prevailed since the inception of the income tax by adopting a mandatory carryover basis approach to taxing acquisitions.

V. RELATIONSHIP BETWEEN CORPORATE AND SHAREHOLDER LEVEL TAX

To this point the analysis has been limited to the proper taxation of a corporate acquisition at the corporate level; no consideration has been given to the implications of a mandatory carryover basis pattern of taxation at the shareholder level. Under a rigorous approach to the separate entity concept, that treatment of acquisitions would be sufficient; there would be no shareholder level implications of the configuration of the corporate tax. If, in connection with a change in ownership of an incorporated business, a shareholder disposed of his or her stock, the transaction would be taxable in accordance with the rules of the individual income tax. Historically, however, the taxation of corporate acquisitions has involved interrelated consequences at both the corporate and shareholder levels.

Without doubt, shareholders who actually receive cash or property, other than a security in a corporate party to the acquisition, must be subject to immediate income taxation. The open issues are the extent to which a shareholder not receiving cash or property can ever be entitled to nonrecognition, on the one hand, and the extent to which such a shareholder must be subject to tax, on the other. Neither issue has any implications for the integrity of the corporate level tax. Carryover basis preserves that tax and further requires that the burden of that tax be borne by the target corporation and its shareholders through the implicit tax caused by the purchase price for the business. Rather, these issues relate to the integrity of the shareholder level tax.

A. Nonrecognition

In its elementary form, under current law, the target shareholders will be taxed upon a transfer of their stock to the acquiring corporation or upon redemption by the target corporation unless the transaction consti-
tutes a reorganization. In that event, which implies that a substantial fraction of the target shareholders obtain an equity interest in the acquiring corporation, target shareholders receiving such an interest are not subject to a current tax. Rather, like the target corporation itself, their gain is deferred in the basis of the replacement stock. Thus, nonrecognition at the shareholder level requires the presence of an acquisition and that all or a substantial portion of the target shareholders obtain stock in the acquiring corporation.

The circumstances, if any, under which shareholders of the target should be entitled to nonrecognition treatment on the receipt of stock in the acquiring corporation is an issue of policy that has no technical significance to the basic proposal made here. The desirability of a mandatory carryover basis pattern of taxation would not be affected by whether nonrecognition at the shareholder level is always prohibited, granted only if a specified fraction of the target shareholders received stock in the acquiring corporation, or granted on a shareholder-by-shareholder basis. However, it is likely that any system for taxing corporate acquisitions that would be adopted would include some potential for nonrecognition at the shareholder level. Just as appealing cases for nonrecognition at the corporate level would likely bar the adoption of a mandatory cost basis pattern of taxation, similar cases involving little substantive change in the business would undoubtedly result in the adoption of a mechanism for extending nonrecognition at the shareholder level.

Providing for nonrecognition at the shareholder level, however, would unavoidably reintroduce a measure of the complexity that the proposal here would otherwise eliminate from the taxation of acquisitions. Plainly, not every occasional exchange of stock in one corporation for stock in another can be entitled to nonrecognition; only exchanges in connection with a change in the ownership of a business could be eligible. That precondition poses no obstacle to defining the scope of shareholder nonrecognition following an asset acquisition. Under the proposal made here, acquisitive and nonacquisitive asset transfers would be distinguished. Shareholder level nonrecognition, if it is to be granted, would be available only upon the distribution of securities of an acquiring corporation following a carryover basis acquisition.

If nonrecognition is to be permitted following as asset acquisition, considerations of neutrality would seem to require comparable treatment following a stock acquisition. However, for the purposes of the corporate level consequences of an acquisition, the proposal would eliminate a stock transfer based definition of an acquisition. Thus, extending nonrecognition at the shareholder level following a stock acquisition would require reintroducing a definition of a stock acquisition for the purpose of
establishing the precondition for nonrecognition treatment at the shareholder level.

The reintroduction of such a definition would not be incompatible with the substantive proposals made here for imposing carryover basis treatment at the corporate level. For that purpose, a stock transfer based definition of an acquisition was abandoned because it was not consistent with the implementation of a mandatory carryover basis system. A definition of a stock acquisition that would only be relevant to a determination of the shareholder level consequences of the transaction and not to the corporate level consequences would be essentially unrelated to the carryover basis system.

Similarly, the introduction of a stock based definition of an acquisition for this purpose would not unduly detract from the simplification sought by this proposal. Under present law, nonrecognition at the shareholder level is, in effect, a part of the definition of a reorganization and thus directly affects the corporate level consequences of a transaction. As a result, defining the scope of shareholder nonrecognition is of considerable importance, and little flexibility exists in the range of acceptable definitions. Under the proposal here, however, shareholder level tax consequences would have no impact on the treatment of the transaction at the corporate level. The scope of shareholder nonrecognition, therefore, would be fashioned without reference to a corporate level effect, but, far more rationally, solely by reference to whatever policy justification for shareholder nonrecognition is found to exist. For example, shareholder nonrecognition might be available to any shareholder who exchanged target stock for stock of a second corporation which owned or was acquiring over 50% of the stock of the target, wholly without regard to the nature of the consideration received by the other target shareholders. Further, nonrecognition might be barred for exchanges of publicly traded securities or where publicly traded securities were received in exchange for nonpublicly traded target securities.

B. Mandatory Shareholder Level Taxation

The question of whether, under certain circumstances, the price for a carryover basis at the corporate level should include a shareholder level tax is of greater importance. Historically, an immediate shareholder level tax has not been required for carryover basis treatment when the consideration for the acquisition was stock of the acquiring corporation. In such a reorganization, the shareholder level tax, like the corporate level tax, was deferred in the basis of the stock received. Absent reorganization characterization, however, the pattern was less clear. In a stock purchase, the shareholders were by definition subject to tax notwithstanding the carryover basis at the corporate level—a somewhat inconsis-
tent result. In an asset purchase, the same immediate shareholder level tax was required by the statutory extension of the General Utilities doctrine in old § 337. However, § 337 extended a complete exemption from the corporate level tax, rather than a deferral, and the insistence upon a liquidation producing a shareholder level tax merely required that one level of explicit tax be imposed upon the asset transfer. Had prior law more correctly provided for a deferral of the corporate tax on an asset acquisition, it is unclear whether the shareholder level tax would have been regarded as essential.

In principle, there is no reason to require an immediate shareholder level tax following a carryover basis asset acquisition even when the consideration is entirely in cash. The target corporation will have been required to bear an implicit tax in the transaction through an adjustment to the purchase price. As a result, the net proceeds of the sale held at the corporate level should correspond to the after-tax proceeds of a taxable sale, increased by the share of the benefit from the deferral of the corporate tax that is obtained by the target. Since a shareholder level tax has never been thought necessary following a taxable sale of assets, there seems to be no reason for such a requirement following a carryover basis acquisition. Thus, in principle, a carryover basis asset acquisition should not require the liquidation of the target or other mandatory imposition of tax at the shareholder level.

If the target corporation in an asset acquisition is not required to distribute the proceeds of the sale, the taxation of acquisitions at the shareholder level may differ, depending upon whether an asset or stock acquisition is used. To the extent that the consideration for the acquisition consists of cash, the shareholders of the target would be able to elect between a taxable stock sale or a nonrecognition asset sale. However, if

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116 There is one difference between cost and carryover basis acquisitions that might be thought to require the distribution of the proceeds of a carryover basis acquisition if a preferential rate of tax on capital gains were reintroduced. In a carryover basis acquisition, the earnings and profits account of the transferred business would pass to the acquiring corporation. Following the transfer of all of the assets of a nonsubsidiary corporation, the target corporation would hold substantial liquid assets but would not have any earnings and profits. The resulting ability of the target to make periodic distributions to its shareholders that are not taxable as dividends could be viewed as excessively favorable. However, such a target corporation would be subject to a corporate level tax, and would generate earnings and profits, to the extent of the return on its investment of the proceeds of the acquisition. Subjecting that return to double taxation at ordinary income rates would in fact constitute a sufficient income tax burden.

Indeed, if capital gains were preferentially taxed, a substantial incentive would exist for the target shareholders following any form of asset acquisition to voluntarily accept a taxable distribution from the target corporation. The immediate distribution of the proceeds of a carryover basis transfer would be favorably taxed, while deferred periodic distributions would attract double taxation and ordinary income treatment. That incentive, at least in smaller corporations, may accomplish nearly the same result as a compulsory distribution requirement.
in a stock acquisition the target shareholders are permitted to receive stock of the acquiring corporation without an immediate tax, either as under current law or as suggested above, that election at the shareholder level will exist in all events. No greater deferral of tax would be created by not taxing shareholders who simply retained their target stock. Accordingly, the requirements of the shareholder level tax do not compel the taxation of the target shareholders who retain stock in the target corporation. And, since the corporate level tax is preserved in the carried over basis, there is no technical necessity for insisting upon a distribution by the target corporation.

The consequence of not requiring an actual or constructive distribution to shareholders following either a cost or a carryover basis asset acquisition is to permit the shareholders of the target corporation to defer taxation on the appreciation in the value of the target corporation, notwithstanding that the corporation has entirely disposed of the appreciated business. Certainly it would not be unreasonable to view such a transaction as a disposition by the shareholders of the target that ought to be taxed to them. Such a rule, however, would be tantamount to requiring a contraction of target corporations in the wake of any disposition of a business activity. Whether, and to what extent, such a requirement would be wise raises an issue of policy that goes beyond the technical requirements of the income tax and the scope of this article. Either resolution of that issue is entirely consistent with the proposal made here. Since there is no greater technical necessity for a distribution requirement following a carryover basis acquisition than following a cost basis acquisition, the question of mandatory distributions to shareholders can be resolved independently.117

C. Corporate Shareholders

Some of the greatest conceptual difficulties in the design of a pattern for taxing all corporate transactions, including acquisitions, stem from the relationship between parent and subsidiary corporations. The taxing system has never consistently treated either the parent corporation as a mere investor in the subsidiary or the corporate group as a single entity.

117 Other issues of tax policy, however, might well affect the ultimate decision to impose a distribution requirement following at least some carryover basis acquisitions. In light of the basis adjustment without tax extended at death, IRC § 1014, for example, Congress might well conclude that the carryover basis acquisition of at least a closely held, nonsubsidiary corporation should be accompanied by a shareholder level tax.

Also, it was observed above that the greatest pressure on the proposed definition of an acquisition would come from efforts to convert ordinary sales into carryover basis acquisitions. Some form of distribution requirement would impose a cost on acquisition treatment that would deter these attempts. A distribution requirement tailored to potentially abusive situations, perhaps waivable in the discretion of the Commissioner, might thus be found desirable.
Thus, on the sale of stock in the subsidiary, it is not clear whether the
transaction should be taxed in the same manner as the sale of a nonsub-
sidiary corporation or should be viewed as the sale of business assets by
the parent corporation.\footnote{118}

Notwithstanding the historical ambiguity, however, if a subsidiary cor-
poration is subject to the same rules that govern nonsubsidiary corpora-
tions, multiple tiers of taxation will be imposed. If a sale of the stock of
the subsidiary is fully subject to tax but the basis of the assets of the
subsidiary are not affected by the transaction—as would occur upon the
sale of nonsubsidiary stock—a third level of tax will be imposed upon
that incorporated business upon a later sale of the acquired assets. The
potential for multiple tiers of taxation is a byproduct of the repeal of the
\textit{General Utilities} doctrine. Prior to repeal, while the sale of the subsidiary
stock might be taxable, the assets of the subsidiary could obtain a step up
in tax basis without further tax.

While the two levels of tax that resulted from the repeal of \textit{General
Utilities} have been embraced by many advocates of that change in the
law, multiple tiers of taxation have not. Rather, a consensus seems to
have emerged that such a third or greater tier tax is neither necessary nor
appropriate to the integrity of the corporate income tax. Accordingly, a
series of recent amendments to current law permits the parties to the sale
of stock in a subsidiary to treat the transaction as a sale of the assets of
the subsidiary.\footnote{119} At present, the effect of that election is to forgive the
third tier tax on the stock sale provided that the constructive asset sale is
treated as a fully taxable, cost basis acquisition.\footnote{120} Under the mandatory
carryover basis proposal made here, the corporate tax on an asset sale
would be deferred, rather than immediately imposed. However, that
deferral of the corporate level tax on the appreciation in the assets of the
subsidiary does not alter the propriety of forgiving the third tier tax on
the transfer of the stock of the subsidiary. Presumably, therefore, under
the proposal made here, the sale of stock in a subsidiary should continue
to have the same consequences to both the seller and purchaser as would
the sale of the assets of the subsidiary.

The result should not be different if the selling corporate shareholder
disposes of less than all of the stock of the target subsidiary, either be-
cause it owned less than all of the stock or because it retained some por-
tion of the stock. The mandatory feature of the proposal here would be
wholly undermined if these "creeping dispositions" could avoid the car-

\footnote{118} The Reporter's proposals on intercorporate dividends which accompany the American
Law Institute study seek avenues for rationalizing this area. See Subchapter C Project, note 9,
at 490-513.
\footnote{119} IRC §§ 338(h)(10), 336(e).
1986-3 C.B. (vol. 4) 173.
ryover basis system. The sale of a fraction of the stock of a subsidiary is the functional equivalent of a sale of an undivided interest in the underlying assets of the target. If the assets in question consist of a business and thus would produce a carryover basis acquisition if entirely sold, the sale of a fraction of the business should not produce a different result. A fractional sale of assets thus should be a carryover basis transaction. The same consequence should attach to a sale of stock. Therefore, the sale of less than all of the stock of a target subsidiary must also be a carryover basis transaction to the selling and purchasing corporate shareholders.

On the other hand, the sale of stock that represents a mere portfolio investment of working capital plainly is not entitled to the consequences of a corporation acquisition. Rather, such ordinary business transactions should be fully taxed. The line between the sale of a portfolio investment and a disposition of a portion of a subsidiary obviously lacks economic definition and must be arbitrary. Existing law, however, provides such a definition for other purposes of the tax law. Under § 243,121 for example, the amount of the intercorporate dividends received exclusion is reduced for stock held as a mere portfolio investment. Presumably, a consistent line should be drawn for the purposes of defining an acquisition.

CONCLUSION

The question of how a corporate acquisition ought to be subject to tax does not have a technically perfect answer. The fundamental structure of the taxing system contains inherent contradictions which preclude deriving an answer that can be defended through the elaboration of principles upon which all students of taxation would agree. As a result, rationalizing this area of the taxing system requires identifying the pattern of taxation that will result in the least economic distortion and will be most compatible with the other broad feature of the legal system. The suggestion here is that those requirements are best achieved through a mandatory carryover basis system.

Regardless of the merits of this proposal, however, the need to quite generally overhaul the taxation of corporate acquisitions is entirely evident. Moreover, any such revision must be comprehensive, including both taxable and reorganization acquisitions within a single scheme. Seventy years of ad hoc statutory and judicial development have resulted in a framework that is needlessly complex, internally inconsistent, and noted for its irrationality. The issue is no longer whether this area of the law should be revised; rather, it is the way in which that revision should be directed.

121 IRC § 243(c).