TAX POLICY AND CHANGES TO SUBCHAPTER C

WILLARD B. TAYLOR*

I

INTRODUCTION

Serious consideration was given in the late 1970's to proposals to integrate corporate and individual income taxes. These proposals focused primarily on plans which would allow shareholders who received dividends from domestic corporations to be given an income tax credit for all or a part of the corporate tax paid on the income from which the dividends were paid.¹ The argument for allowing shareholders to have a tax credit to offset the corporate tax paid was primarily economic: that it would increase the funds available for investment by corporations and, by making equity securities a relatively more attractive investment than before, increase the portion of corporate funds raised through the issuance of equity securities. Since the idea was to encourage distributions to shareholders, integration also implied a relatively high capital gains tax, at least on the sales of corporate stock, in order to tax retained corporate earnings at a relatively high rate.

While increasing corporate investment has undeniably continued to be a goal of tax legislation since the integration debate, it is apparent that, at least through the 1984 Tax Reform Act,² we have come full circle, choosing instead to reduce corporate tax liabilities by larger deductions and credits, to reduce the capital gains tax for individuals (and thus the tax burden on retained corporate earnings), and to strengthen the taxation of corporate distributions to shareholders. This approach to increasing corporate investment began with the Tax Reform Act of 1979³ and has been continued by subsequent legislation. The Treasury tax reform proposals⁴ made at the end of 1984 would reverse this trend, but their future is uncertain.

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1. E.g., U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977); STAFF OF THE JOINT COMM. ON TAXATION, 95th Cong., 1st Sess., TAX POLICY AND CAPITAL FORMATION (Comm. Print 1977); Feldstein & Frisch, *Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals*, 30 NAT'L TAX J. 37 (1977); C. McLURE, MUST CORPORATE INCOME BE TAXED TWICE? (1979).

2. Pub. L. No. 98-369, 98 Stat. 494.

3. Pub. L. No. 95-618, 92 Stat. 3174.

4. U.S. DEP'T OF THE TREASURY, REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984)(in three volumes: Vol. 1, Overview; Vol. 2, General Explanation of the Treasury Proposals; and Vol. 3, Value-Added Tax) [hereinafter cited as TREAS. REPORT].

II

THE 1981 AND 1982 ACTS

Subchapter C was certainly not the focus of the Economic Recovery Tax Act of 1981,⁵ which essentially left Subchapter C untouched except to provide on a temporary basis for the tax-free reinvestment of certain public utility dividends,⁶ rules for reorganizations of financially troubled thrift institutions,⁷ and for the effect of the new ACRS deductions on corporate earnings and profits.⁸ There was no similar lack of attention to Subchapter C in the Tax Equity and Fiscal Responsibility Act of 1982.⁹ With some spirit of true tax reform, but more inspired by perceived abuses, Congress made a number of significant changes to Subchapter C, of which by far the most far-reaching were the amendments relating to the tax basis of an acquired corporation's assets after a purchase of its stock.¹⁰

A. Treatment of Acquisitions

When a corporation is acquired for a premium (i.e., a price in excess of its net worth on a tax basis), a natural inquiry is whether the premium can be assigned to the corporation's assets and recovered through depreciation or otherwise in computing taxable income. The 1939 Code provided no mechanism for such a reevaluation when the acquired corporation's stock was acquired, but the courts in the *Kimbell-Diamond* line of cases¹¹ held that a purchase of stock by one corporation followed by a prompt liquidation of the acquired corporation would be treated from the purchaser's perspective as an acquisition of the acquired corporation's assets, and this became part of the Internal Revenue Code with the enactment of section 334(b)(2) in 1954. That section provided in substance that if there were a purchase of control of one corporation by another followed by a liquidation of the acquired corporation, the basis of the acquired corporation's assets would be the price paid for its stock increased by assumed liabilities of the acquired corporation. Thus, the purchasing corporation could, by liquidating the acquired corporation or not, elect to revalue its assets.

No particular tax policy was served by requiring a liquidation to effect what might have been a straightforward election, and the liquidation requirement could be a major headache where there were nontax reasons for

5. Pub. L. No. 97-34, 95 Stat. 172.

6. I.R.C. § 305(e) (Lawyers Co-op. 1983).

7. *Id.* § 368(a)(3)(D) (amended 1984).

8. *Id.* § 312(K)(3) (amended 1984).

9. Pub. L. No. 97-248, 96 Stat. 324.

10. See *infra* notes 15-26 and accompanying text.

11. *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951); see also *United States v. M.O.J. Corp.*, 274 F.2d 713, 716-17 (5th Cir. 1960); *United States v. Mattison*, 273 F.2d 13, 17-20 (9th Cir. 1959); *Georgia-Pacific Corp. v. United States*, 264 F.2d 161, 162-66 (5th Cir. 1959); *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691-92 (5th Cir. 1954); *Montana-Dakota Utils. Co. v. Commissioner*, 25 T.C. 408, 415-16 (1955), *acq.* 1956-2 C.B. 7.

continuing the acquired corporation and its subsidiaries. In practice, moreover, section 334(b)(2) did not work very well, at least from the Internal Revenue Service's point of view. The parallel between a purchase of assets and a purchase of stock followed by a liquidation was not complete. Since the liquidation could be pursuant to a plan adopted as long as two years after the acquisition, and distributions might continue for several years thereafter, the assets actually distributed might be quite different than those held by the acquired corporation at the time its stock was purchased. Adjustments to basis for the period between the stock acquisition and the liquidating distributions could result at a higher basis under section 334(b)(2) than on a direct purchase of assets, essentially because of the treatment of interim earnings and profits.¹² Since the recapture resulting from a section 334(b)(2) liquidation was incurred after the acquisition, it could (unlike the recapture incurred on a sale of assets) be offset by losses and other attributes of the purchaser. Section 334(b)(2) was also selective insofar as it provided for a separate election for each of the purchased corporation's subsidiaries.

More important, it was perceived in the late 1970's that if there was a "partial liquidation" of the acquired corporation, which would be the case so long as some minimal assets were retained, the basis of the distributed assets would, under the consolidated return regulations, be adjusted to reflect the price paid for the acquired corporation's stock and any liabilities assumed, essentially as if there had been a section 334(b)(2) liquidation, but that not all assets had to be distributed and that any recapture of investment tax credit and most of the cost of any other recapture on the distributed assets would be eliminated.¹³ Consistent with the rules governing sales of assets, section 334(b)(2) had never overridden the provisions of the Internal Revenue Code providing for the recapture of investment tax credit, depreciation, and other items, and with the expansion of the recapture concept to include more and more items, the cost of recapture had become a major impediment to a section 334(b)(2) liquidation. Against that background, partial liquidations were a bonanza.

The possibility of partial liquidations drove the changes made by the 1982 Act. While proposals to reform the acquisition rules were introduced in Congress in the late spring of 1982,¹⁴ they might well have died but for the acquisition of Marathon Oil by United States Steel. With the extensive publicity given to the partial liquidation of Marathon Oil, the acquisition proposals gained broader support and became part of the 1982 Act. As might be expected, the amendments did not (because of their effective dates) affect the partial liquidation of Marathon, but they attempt to ensure that it would no longer be possible to do the same thing.

12. Treas. Reg. § 1.334-1(c)(4)(v)(a) (1984); e.g., *R. M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 323-28 (1977), *aff'd on other grounds*, 591 F.2d 248, 255 (3d Cir.), *cert. denied*, 444 U.S. 828 (1979); *First Nat'l State Bank of New Jersey v. Commissioner*, 51 T.C. 419, 427-28 (1968).

13. Treas. Reg. §§ 1.1502-1.1514(c), 1.1502-1.1531(b)(2)(ii) (1984).

14. Corporate Takeover Tax Act of 1982, H.R. 6295, 97th Cong., 2d Sess. (introduced by Representative Stark).

Broadly speaking, the 1982 Act replaced the liquidation requirement with a straightforward election, sought to conform the treatment of a stock purchase followed by an election to the treatment of a sale of assets, and to eliminate any selective write-up of assets.¹⁵ More specifically, the 1982 Act replaces section 334(b)(2) with section 338 under which, when there has been a qualifying stock purchase of one corporation by another, the purchaser may elect to treat the assets of the acquired corporation as having been sold to a new corporation for the price paid for the stock plus the liabilities of the acquired corporation.¹⁶ The goal of section 338 is to conform the treatment of a stock acquisition followed by such an election to the treatment of the sale of assets. The election must be made promptly and in any event results in a sale on the date of the qualifying stock purchase so that changes in the assets of the acquired corporation subsequent to the stock purchase have no effect on the tax treatment.¹⁷ Also, the optional sale occurs prior to consolidation by the purchaser and so any recapture cannot be offset by the purchaser's losses or other tax attributes.¹⁸ Partial liquidations are in effect abolished, except for the tax treatment of certain noncorporate shareholders, and elaborate rules are prescribed to ensure that all assets of the acquired corporation and its affiliates are treated consistently as having been purchased or not for tax purposes.¹⁹

B. Treatment of Redemptions

In addition to replacing section 334(b)(2) with section 338, the 1982 Act also revised the statutory rules that provided for nonrecognition of gain by a corporation on a reacquisition of shares of its stock for appreciated property.²⁰ As originally enacted, the 1954 Code generally provided for the nonrecognition of gain by a corporation on the distribution of property as a dividend, in redemption of its stock or in liquidation.²¹ There were limited exceptions (i.e., for distributions of LIFO inventories and installment obligations), but apart from these, the 1954 Code explicitly incorporated the *General Utilities*²² rule "that a corporation does not realize gain by reason of distribution of its property."²³ The nonrecognition afforded to redemptions was narrowed in 1969 in response to a number of offers by publicly-held corporations to repurchase shares of their stock for appreciated holdings of stock in other corporations, but important exceptions remained.²⁴ There was

15. See I.R.C. § 338 (Lawyers Co-op. 1983) (amended 1984).

16. *Id.* § 338(a).

17. *Id.*

18. *Id.*

19. *Id.* § 338(e), (f), (h).

20. I.R.C. § 311(d) (West 1978), amended by I.R.C. § 311(d) (Lawyers Co-op. 1983) (amended 1984).

21. *Id.* § 311(d) (West 1978).

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

23. S. REP. NO. 1622, 83d Cong., 2d Sess. 247 (1954); H. R. REP. NO. 1337, 83d Cong., 2d Sess. 37 (1954).

24. Pub. L. No. 91-172, 83 Stat. 487 (1969).

nonrecognition of gain if the property used in the redemption consisted of stock or an obligation of a 50% or greater owned subsidiary, and nonrecognition was relied on in a number of transactions to convert what otherwise might have been a taxable sale of a corporate asset into a nontaxable transaction. Thus, Mobil tendered the stock of Esmark and, pursuant to an agreement with Esmark, swapped the stock it acquired for an Esmark subsidiary, Vickers Energy. The hope was that this would avoid the gain that would have been recognized had Vickers simply been sold for cash. There was also no recognition of gain on the complete redemption of a stockholder that for at least one year had owned at least 10% of the redeeming corporation's stock.

Responding to Mobil-Esmark and other transactions, the 1982 Act repealed almost all of the broad-based exceptions to nonrecognition of gain on a redemption of stock, limiting the exceptions to redemptions of noncorporate shareholders with substantial and long-term holdings of the corporation's stock.²⁵ Was such a broad-based repeal needed to deal with these transactions? It was unclear whether Mobil-Esmark worked under present law, and even if it did, it could have been cut off by requiring the redeemed shareholder to have, say, a one year holding period. No doubt, the failure to adopt more modest changes reflected a deep-seated view that it was appropriate for corporations to recognize gain on *all* distributions of appreciated property in redemption of stock.

Providing for the recognition of gain on redemptions of stock made with appreciated property was, of course, a further erosion of the *General Utilities* principle that no gain is realized on a disposition of property by way of distribution to shareholders. This was not unrelated to the replacement of section 334(b)(2) in the sense that one perceived abuse to which section 338 was directed was the ability to get a step-up in basis without the recognition at the corporate level of the tax that would have been paid had the assets of the acquired corporation been sold and the corporation liquidated.²⁶ Certainly the congressional staffs perceived this connection, and the relationship between achieving a cost basis for the assets of an acquired corporation and the gain by the acquired corporation became explicit when they turned again to Subchapter C.

C. The Subchapter S Revision Act

The 1982 Act was followed by the Subchapter S Revision Act of 1982.²⁷ Although not directed at Subchapter C, that legislation is nonetheless relevant. In the first place, by expanding eligibility for S-corporation

25. I.R.C. § 311(d)(2)(A), (B) (West 1978), *amended by* I.R.C. § 311(d) (Lawyers Co-op. 1983) (amended 1984).

26. STAFF OF THE JOINT COMM. ON TAXATION, 97th Cong., 2d Sess., SUMMARY OF THE REVENUE PROVISIONS OF H.R. 4961, at 131-41 (Aug. 24, 1982).

27. Pub. L. No. 97-354, 96 Stat. 1669.

treatment,²⁸ it made S-corporation treatment a substantially more viable alternative to Subchapter C. This occurred at a time when there was already evidence of "disincorporation," that is, a flight from Subchapter C. The use of depositary receipts for limited partnership interests (i.e., of ADR's) had made possible the growth of publicly-traded limited partnerships, at least where it was possible to effect a section 754 election so that the price paid by new partners would be reflected in their shares of partnership taxable income; and a number of the smaller oil companies had established publicly-traded royalty trusts, largely through distributions to their shareholders. In addition, the Subchapter S Revision Act had to deal with the transition between Subchapter S and Subchapter C status, that is, what happens when an existing corporation makes an S election and when an S election terminates. Section 1375 accomplished this by confirming that an S election was not a liquidation and a termination of an S election was not an incorporation, but also by imposing corporate tax on the "excess net passive income" of a former non-S corporation that had accumulated earnings and profits and passive income in excess of 25% of gross receipts and making such a corporation ineligible for continued S treatment if it had passive income in excess of 25% of gross receipts for three consecutive years.²⁹

The Subchapter S Revision Act also provided that S corporations would recognize gain on any distribution of appreciated property to its shareholders.³⁰ The theory was that otherwise the gain would be permanently untaxed since it would be acquired by the shareholders with a fair market value basis. As that would be true whether or not there was an S election, this change should be viewed as prefiguring the extension of the same rule to corporations taxed under Subchapter C.

III

THE SUBCHAPTER C STUDY

The changes made to Subchapter C in the 1982 Act were evidently an inspiration to the congressional staffs to do more. This part of the 1982 Act was widely criticized, however, not only because of the speed with which the changes were enacted but also on a substantive level. The rules in section 338 that were intended to enforce consistent treatment of all assets of the acquired corporation and its affiliates went far beyond what was necessary, and the question was raised as to whether changes in the rules for nonrecognition of income on distributions of appreciated property should have been adopted without consideration of the overall effect on the tax system. The criticism had some effect and led to a more deliberate process.

In October of 1982, Senator Dole, Chairman of the Senate Finance Committee, announced that he had directed the Senate Finance Committee

28. *E.g.*, *id.* § 1361(b), 96 Stat. at 1669 (increased from 25 to 35 the permissible number of shareholders).

29. *Id.* § 1362(d)(3), 96 Stat. at 1674, 1684.

30. *Id.* § 1363(d), 96 Stat. at 1677.

Staff to study “corporate mergers, acquisitions and dispositions, net operating losses, and related issues concerning the taxation of corporations and shareholders.”³¹ Thereafter, the congressional staffs formed a group in which a number of practitioners were asked to participate. In September of 1983, after a number of meetings of this working group, the Staff of the Senate Finance Committee came forth with a Preliminary Report on “The Reform and Simplification of the Income Taxation of Corporations.”³²

The proposals made in the Preliminary Report can really be divided into three: first, a number of specific measures, such as those relating to the 85% dividends received deduction, that were not as such related to the main line acquisition and merger provisions, but were nonetheless far reaching and in a number of cases later appeared in the 1984 Act; second, proposals to revise extensively the tax treatment of acquisitions and mergers; and third, proposals with respect to net operating loss and other carryovers following an acquisition.

A. The Acquisition Proposals

With respect to acquisitions and mergers, the Preliminary Report proposed that a simple election should determine whether assets acquired in a “corporate acquisition”³³ would have a carryover (i.e., a historical) tax basis or a tax basis equal to cost, and that the election would be available without regard to whether the acquisition was of stock or assets or whether the consideration for the acquisition is cash, stock, or other property. Thus, for example, a cash acquisition of assets could be treated as a carryover basis transaction and an all-stock merger as a cost basis transaction.

No cost basis election would be available for acquisitions between related parties (i.e., where there was 50% or more common ownership of the acquired and acquiring corporation). The election would, in general, be made on a corporation-by-corporation basis so that, for example, one election could be made with respect to the assets of an acquired parent corporation and another with respect to the assets of a subsidiary of that corporation. A limited consistency rule would make the election govern the basis of an asset held by the target corporation within one year prior to the corporate acquisition and acquired by the acquiring corporation within one year on either side of the corporate acquisition. The “consistency” rules of section 338 would be conformed.

31. Press Release of Senator Bob Dole (October 28, 1982).

32. STAFF OF SENATE COMM. ON FINANCE, THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS, 98th Cong., 1st Sess. (Comm. Print 1983).

33. *Id.* at 55-57. A qualifying corporate acquisition could be an acquisition of stock or of assets. A stock acquisition would be qualified if stock possessing 80% of the voting power and 80% of all other stock (except for nonvoting, nonparticipating preferred stock) is acquired in a 12-month period from unrelated persons. An asset acquisition would be qualified if effected through a statutory merger or consolidation, or a transaction or a series of transactions in which one corporation acquires substantially all the assets of another corporation.

As the price of a cost basis election and a relaxation of the section 338 consistency rules, however, the Preliminary Report proposed full recognition of corporate gain and not just the recognition of "recapture" required by present law.³⁴ Thus, if a cost basis was elected for the assets of an acquired corporation, the acquired corporation would recognize gain or loss to the full extent of any appreciation or depreciation in the value of its assets, except that there would be separate elections to acquire goodwill and stock in foreign corporations and DISC's with a carryover basis and without the recognition of gain or loss. As a consequence, subject to those separate elections and (as discussed below) the possibility of more general relief, the price of a step-up would be full recognition of gain (and recapture of investment credit) by the acquired corporation.

If a carryover (or historical) basis were elected for the assets of an acquired corporation, the acquired corporation would not recognize gain (provided, in the case of an asset acquisition, that the acquired corporation were liquidated and the consideration received and any retained assets distributed to its shareholders), and the tax basis and other attributes of the acquired corporation would carry over (substantially as though there had been a "reorganization" under present law).

The Preliminary Report proposed that stock received by a shareholder in a corporation acquisition be tax free, regardless of whether the acquisition is within the present law definition of a "reorganization," shareholders receive cash or property other than stock, or the assets of the acquired corporation are or are not "stepped up."³⁵ Thus, there would be no "continuity of interest" requirement and the treatment of shareholders would be determined separately from the treatment of the corporations involved in the acquisition. Stock for this purpose would include stock of the acquiring corporation and of any affiliated corporation above it in the chain of affiliation.

As under present law, if a shareholder received cash or other property in addition to stock, the Preliminary Report proposed that the cash or other property might or might not be a dividend, but, unlike present law, the amount of the dividend would not be limited to the realized gain, and dividend treatment would be determined by looking at the reduction in the shareholder's interest in the acquiring corporation, not the acquired corporation, with the result that pro rata payments of cash to the acquired corporation's shareholders may be treated as capital gain.³⁶ For example, if the shareholders of an acquired corporation received stock worth \$100x and cash of \$33x, and the stock represented 10% of the acquiring corporation's stock, the gain recognized by the acquired corporation's shareholders on account of the cash would be capital gain since the transaction would be viewed as though the shareholders had received stock representing 12.85% of

34. *Id.* at 60-61.

35. *Id.* at 62-64.

36. *Id.* at 63-64.

the acquired corporation's stock and then surrendered 2.875% for cash, a reduction in interest of more than 20%.

In recognition of the fact that the broad repeal of *General Utilities* was unlikely to be acceptable, the Preliminary Report recommended that the Senate Finance Committee consider a number of possible measures to provide some relief from the capital gains tax that would otherwise be imposed on corporations that distributed appreciated property to shareholders in a liquidation or are acquired in cost basis acquisitions or mergers including (i) an exemption or phase-in of the capital gains tax payable by the corporation on capital assets that had been held for a long period of time, (ii) a shareholder credit for the capital gains tax payable by the corporation, or (iii) a reduction in the rate of corporate or shareholder capital gains tax.³⁷ In general, these measures would only provide relief from the tax payable by the corporation on capital assets; they would not provide relief with respect to ordinary income assets, such as inventory. Since *General Utilities* would be overruled and relief limited to capital gain, it would in any event be possible to repeal the collapsible corporation provisions of the Internal Revenue Code.

B. The Carryover Proposals

The Preliminary Report also addressed the treatment of net operating loss and other carryovers following a corporate acquisition or a merger.³⁸ This treatment had been an area of focus since 1976 when, in the Tax Reform Act of 1976,³⁹ Congress revised the rules. Responding to criticism, however, Congress has successively deferred the effective date of the new carryover provisions.⁴⁰

Both the rules enacted in 1976 (and then deferred) and those which they replaced made the availability of net operating loss and other carryovers turn on the precise form of the transaction and produce widely varying results depending on arguably irrelevant factors. These formalistic rules were overlaid by section 269, which disallowed loss and other carryovers when the principal purpose of the acquisition was to obtain the loss.⁴¹

Under the proposals made by the Preliminary Report, loss and other carryovers will be available following a corporate acquisition or merger only if a carryover basis was elected for the assets of the acquired corporation.⁴² Net operating and capital loss carryovers and carryovers of unused investment and foreign tax credits will then be limited by two rules.

37. *Id.* at 93-94.

38. *Id.* at 67-76.

39. Pub. L. No. 94-455, § 806, 90 Stat. 1520, *codified at* I.R.C. § 1348 (West 1981).

40. Most recently, in the Tax Reform Act of 1984, enacted as Division A of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 62(a), 98 Stat. 494, which deferred the effective date until at least 1986.

41. I.R.C. § 269 (Lawyers Co-op. 1974 & Supp. 1985).

42. STAFF OF SENATE COMM. ON FINANCE, THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS, *supra* note 32, at 68.

Under the first rule (the so-called "merger rule"), relating to acquisitions that are of common or preferred stock, a net operating loss or other carryover can be used against a percentage of the taxable income of the acquiring corporation attributable to the common stock issued in the acquisition, adjusted downward to exclude the part of the stock issued for the loss or other carryover.⁴³ Under a table set out in the Report, the percentage would be .5% for each of the first twenty percentage points of the acquiring corporation's common stock issued to the acquired corporation's shareholders, .75% for each of the next twenty percentage points, 1% for each of the next twenty percentage points, 1.25% for each of the next twenty percentage points, and 1.50% for each of the next twenty percentage points.⁴⁴ The resulting income figure would be further reduced if the acquiring corporation had preferred stock outstanding which is not used in the acquisition to take account of the corporate income tax on the dividends payable on the preferred stock. If preferred stock were issued in the acquisition, the limit would be the yield on the preferred stock and any limit not used in one year could be carried forward.

Thus, if one corporation acquired another by merger for 20% of its common stock, any net operating loss of the merged corporation would be allowable each year until it expired against 10% of the combined taxable income of the acquiring corporation and its consolidated subsidiaries. If the consideration was preferred stock providing for a cumulative annual dividend of \$3 million, the net operating loss of the acquired corporation would be allowable each year during the carryover period against \$3 million of the combined taxable income of the acquiring corporation and its consolidated subsidiaries plus any part of the limitation not used in a prior year. If the consideration was 20% of the acquired corporation's common stock and a preferred stock providing for a cumulative annual dividend of \$3 million, the annual limitation on the use of the loss would be \$3 million plus 10% of combined taxable income in excess of \$3 million and any part of the \$3 million not used in a prior year.

Under the second rule (the so-called "purchase rule"), relating principally to acquisitions for cash or property other than stock, a net operating loss or other carryovers will be allowable each year up to the amount of an interest-like after-tax rate of return on the purchase price; the Report suggests, for example, 125% of the interest rate on income tax deficiencies. Thus, if one corporation acquired another for \$50 million in cash, and the rate of return were 15%, the loss of the acquired corporation would be allowable against the combined taxable income of the acquiring corporation and its consolidated subsidiaries in each year during the carryover period to the extent of \$7.5 million plus the part of the limitation not used in a prior year.

The merger and purchase rules could both apply so that, for example, if a loss corporation were acquired for \$10 million in cash and 5% of the insurer's

43. *Id.* at 71.

44. *Id.* at 72.

common stock (assuming that the rate of return were 15%), the net operating loss of the acquired corporation would be allowed each year against the combined taxable income of the acquiring corporation and its consolidated subsidiaries. That loss would be allowed to the extent of \$1.5 million, 2.5% of combined taxable income in excess of \$1.5 million, and any part of the \$1.5 million not used in a prior year.

Under both the merger and purchase rules there would be no incentive to acquire a corporation that had no assets other than a carryover since, in effect, the acquiring corporation would be paying more than the value of the tax benefit; nor, in cases where the loss corporation had business assets, would there be any incentive to pay more for the loss than it was worth to the acquired corporation.

The limitation on net operating loss and other carryovers would be triggered by redemptions and new issuances of stock by a loss corporation, and there would be special rules for "built in" gains and losses.

C. Reaction to the Preliminary Report

The reaction to the Preliminary Report was confused by inclusion in the Report of proposals that were essentially unrelated to the main line acquisition and attribute carryover proposals. The subsequent debate, and the hearing held by the Senate Finance Committee, focused principally on issues such as whether, as the Preliminary Report proposed, publicly-traded limited partnerships should be treated as corporations and whether 85% dividends should receive the deduction denied to debt financed stock. Only bar associations and other disinterested observers, therefore, spent any time on the acquisition and carryover rules.⁴⁵

Leaving aside the question of relief from the repeal of *General Utilities*, it was hard for any objective observer to do other than applaud the basic acquisition and carryover proposals. No one can honestly defend the formalistic merger and acquisition rules in Subchapter C. The Preliminary Report's proposals, which relied heavily on the work of the American Law Institute, were well thought through and undeniably sound.⁴⁶ The question evolved, therefore, into the price to be paid for reform; that is, whether the acquisition rules need be accompanied by a complete overruling of *General Utilities*; whether, if there were a complete overruling, there should be some relief and, if there were to be relief, the form that it should take.

Although the attribute carryover proposals were the subject of hearings in both the House and Senate, they did not attract much attention, possibly because they made so much more sense than present law or the proposals adopted in 1976. The debate centered on whether it was better, as the

45. *Senate Hearing 98-556 Before the Senate Finance Comm. on Reform of Corporate Taxation*, 98th Cong., 1st Sess. (1983).

46. THE AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT* (Subchapter C 1982); see also Land, *Unallocated Premium in Corporate Acquisitions under the American Law Institute Subchapter C Proposals*, 34 TAX LAW. 341 (1981).

Preliminary Report had proposed, to have both a merger rule and a purchase rule, or whether a single purchase rule would be preferable.⁴⁷ The common purpose of both solutions is to permit the loss or other carryovers to survive only in an amount equal to their value to the acquired corporation at the time of its acquisition or, put differently, to allow no more of the carryovers to be used by the new owners than those which could have been used by the carryover corporation had there been no acquisition. The merger rule does this by limiting the carryovers to the after-tax income attributable to the stock issued in the merger. Because other consideration may also be issued (and the income attributable to some kinds of stock may not be all that easy to determine), the merger rule cannot operate alone and it must be supplemented by a purchase rule. A purchase rule can either limit the loss to the after-tax income which the purchase price will yield at an assumed rate of return or to a principal sum, that is, the sum which invested at that assumed rate of return will produce that income on an after-tax basis.

The argument for a single purchase price rule is that one rule is always more simple than two and only a purchase rule can operate by itself. The contrary argument is that the merger rule is more accurate because it reflects the parties' real agreement, not a calculation based on statutory assumptions as to rates of returns and other matters. It is apparent, in any event, that the differences between the two rules are not nearly as important as their common purpose, which is to neutralize the value of carryovers in acquisitions.

IV

THE 1984 ACT

The 1984 Act did not take up the main line proposals of the Senate Finance Committee staff on acquisitions and mergers and operating loss carryovers. Consideration of operating loss carryovers was deferred and further work on acquisitions and mergers will also presumably wait until 1985 or later.⁴⁸ The Act did, however, follow through on a large number of the other proposals made in the Preliminary Report.

A. Treatment of Dividend Distributions

One of the principal revisions to Subchapter C made by the 1984 Act is to provide, with limited exceptions, for the recognition of gain on dividend distributions of appreciated property to shareholders. That revision reflects the view that "under a double-tax system, the distributing corporation generally should be taxed on any appreciation in value of any property

47. Bacon & Tomasulo, *Net Operating Loss and Credit Carryovers: The Search for Corporate Identity*, 20 TAX NOTES 835 (1983).

48. The Staff of the Senate Finance Committee has spent time on drafting proposals. See, e.g., Bernick, *Dole, Rostenkowski Expected to Continue Drive for Tax Bill*, 22 TAX NOTES 171, 172 (1984).

distributed in a non-liquidating distribution.”⁴⁹ Thus, *General Utilities* is now largely restricted to complete liquidations and certain other limited situations.⁵⁰

Repeal of *General Utilities* for dividend distributions had a double impact on Subchapter C since, in practice, dividends of appreciated property by publicly-held corporations largely have been distributions of units in royalty trusts.⁵¹ The repeal thus slows the move to the disincorporation of assets. The recognition of gain on such a distribution operates as a double deterrent since, in addition to tax at the corporate level, it will generate earnings and profits and thus eliminate for many oil companies the possibility that a royalty trust could be distributed without tax to the shareholders. Along the same lines, in making it clear that there was recapture on the distribution of interests in a partnership, the 1984 Act discourages the use of partnerships to disincorporate.⁵²

B. Earnings and Profits

Other changes that might be in the same category as the treatment of dividend distributions were the provisions expanding the definition of earnings and profits and thus the extent to which corporate distributions will be dividends taxable to shareholders. Although the provisions of the 1982 Act that restricted the use of completed contract accounting were directed at the calculation of taxable income, rather than at earnings and profits, they had the same effect for some contractors.⁵³ Expansions of earnings and profits in the 1984 Act included the amortization for earnings and profits purposes of a number of expenses that are currently deductible in computing taxable income, including: intangible drilling costs; the acceleration for earnings and profits purposes of certain income deferred in calculating taxable income, such as income reported on an installment basis; and the extension for earnings and profits purposes (beyond the extension for taxable income purposes) of depreciable lives on real property, reversing in part rules that had been adopted in the 1981 Act.⁵⁴

The Preliminary Report had proposed the elimination of the earnings and profits concept (with a narrow exception for returns of initial capital), but Congress apparently was persuaded that this went too far and that a more targeted proposal was a better solution, or at least more likely of enactment. Who was right? One difficulty with eliminating earnings and profits is its use in calculating the “deemed paid” foreign tax credit. Another difficulty is that,

49. H.R. REP. NO. 432, Part 2, 98th Cong., 2d Sess. 1190 (1984); S. REP. NO. 169, 98th Cong., 2d Sess. 270 (1984).

50. See I.R.C. § 311(d) (Lawyers Co-op. Supp. 1985).

51. No doubt oil companies that were concerned with attempts by raiders to force such distributions were not indifferent to this provision.

52. I.R.C. § 386 (Lawyers Co-op. Supp. 1985).

53. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 229, 96 Stat. 324, 493-95.

54. Tax Reform Act of 1984, Pub. L. No. 98-369, § 61(a), (b), 98 Stat. 494, 580, 581.

because of the 85% dividends received deduction, dividend treatment is generally better than any other for corporate shareholders. For large corporations, earnings and profits may indeed only be relevant insofar as they affect the calculation of the foreign tax credit. The Act recognized those issues in part, and it deferred the application of some of the new rules to those foreign corporations which derive less than 20% of their gross income from the United States. The Act also limited the new rules in the case of distributions to certain large corporate shareholders.⁵⁵ But, it is questionable whether the earnings and profits limitation should be done away with until these problems have been much more thoroughly explored.

C. Pass-through Entities

One change proposed in the Preliminary Report, not reflected in the 1984 Act, was to treat publicly-traded limited partnerships as corporations. The Preliminary Report had recommended that result essentially on the ground that limited partnerships resembled corporations in their size and operation (describing them as "large, centralized business organizations"). The recommendation could also be justified on the basis that it is almost impossible in a meaningful way to audit a partnership with a large number of ever-changing partners. Such a change would have prevented one major method of avoiding Subchapter C since trusts and other pass-through entities are only available in limited circumstances. The Treasury proposals made in late 1984 endorse corporate treatment of large limited partnerships.⁵⁶

Even though the 1984 Act did not deal with publicly-traded partnerships, the changes it made in the treatment of dividends of appreciated property will have the effect of restricting the growth of these and other pass-through entities, such as royalty trusts, in cases where they are created by distributing interests to shareholders.⁵⁷ The restrictions on "stapled" stock can also be viewed as related to the problem of pass-through entities in the sense that stapling was principally used to staple interests in a regular corporation with interests in an entity not subject to U.S. corporate tax, whether because it was a foreign corporation or a pass-through entity such as a real estate investment trust.⁵⁸ In addition, the 1984 Act made it substantially impossible for an operating company to adopt pass-through status by converting into a regulated investment company.⁵⁹ It did so by denying regulated investment company treatment to any corporation that was not theretofore a regulated investment company unless it distributes out its earnings and profits.⁶⁰ Thus, it will no longer be possible for a corporation which sells its assets and has a sufficient number of shareholders to register under the Investment Company

55. *Id.* § 54, 98 Stat. at 568-71.

56. 2 TREAS. REPORT, *supra* note 4, at 146-50.

57. Pub. L. No. 98-369, § 54(a)(1), 98 Stat. 494, 568-69.

58. *Id.* § 136(a), 98 Stat. at 669.

59. *Id.*

60. *Id.* § 107(a)(3), 98 Stat. at 1049-50.

Act of 1940 in order to elect to be taxed under Subchapter M, unless it first pays out its earnings and profits as a dividend.

D. Other Provisions

Apart from the foregoing, both the 1982 and 1984 Acts include a large number of provisions intended to eliminate what might be perceived as abuses in Subchapter C. In the 1982 Act these provisions consisted of measures designed to eliminate an arguable overlap between the nonrecognition provisions of section 351 and the dividend rules of section 304,⁶¹ an expansion of the definition of section 306 stock⁶² and of the rules for determining dividend equivalency under section 356.⁶³ In the 1984 Act, changes in Subchapter C included: strengthening the accumulated earnings tax provisions;⁶⁴ conforming the stock ownership rules of sections 304 and 368(a)(1)(D);⁶⁵ requiring that the transferor in a "C" reorganization distribute all its assets in liquidation;⁶⁶ revising the consolidated return rule intended to prevent consolidation where less than 80% in value is owned;⁶⁷ and extending the concept of collapsible corporations.⁶⁸

There were also extensive changes to the 85% dividend received deduction in the 1984 Act, principally to reduce the deduction where stock is debt-financed.⁶⁹ The dividends received deduction has been viewed as an essential part of a system of double taxation since it prevents multiple taxation of corporate income as it passes from one corporation to another as opposed to the ultimate individual shareholder. It is unclear why, in the context of this purpose, the allowance of a deduction for interest on debt incurred to purchase or carry stock was viewed as a "double deduction" or otherwise abusive.

V

CONCLUSION

The changes made in Subchapter C by the 1981, 1982, and 1984 Acts were accompanied by a continuing reduction in effective corporate income tax rates. According to the Study of 1982 Effective Tax Rates of Selected U.S. Corporations, prepared by the Staff of the Joint Committee on Taxation,⁷⁰ the average effective corporate income tax rate on the U.S. income of the selected corporations declined from 21.8% in 1980 to 17.2% in 1981 and to 16.1% in

61. Pub. L. No. 97-248, § 226(a), 96 Stat. 324, 490.

62. *Id.* §§ 226(b), 227(a), 96 Stat. at 512.

63. *Id.* § 227(b), 96 Stat. at 492.

64. Pub. L. No. 98-369, § 58(a), 98 Stat. 494, 574; *id.* § 58(b), 98 Stat. at 575.

65. *Id.* § 64(a), 98 Stat. at 584.

66. *Id.* § 63(a), 98 Stat. at 583.

67. *Id.* § 60(a), 98 Stat. at 578.

68. *Id.* § 65(a), (b), 98 Stat. at 584.

69. *Id.* § 51A, 98 Stat. at 562.

70. STAFF OF THE JOINT COMM. ON TAXATION, 98th Cong., 1st Sess., STUDY OF 1982 EFFECTIVE TAX RATES OF LARGE U.S. CORPORATIONS (Comm. Print 1983).

1982. Similarly, the corporate income tax has continued to decline as a proportion of the revenues of the federal government, both as a result of declining corporate income and through the legislated reduction in the corporate tax burden. While in 1950 corporate profits income tax accruals were 28.3% of the total receipts, by 1980 this figure had declined to 13.3%, in 1981 it was 11.5%, in 1982 it was 8.1%, and in 1983 it was under 7%.

The Joint Committee Study also shows a wide variance between the effective corporate income tax rates on different industries. The effective rate of income tax on income from the United States of the selected corporations ranged between over 30% for industries such as trucking, food processors, pharmaceuticals, and tobacco, to rates below 20% for the electronics industry, the petroleum industry, and utilities, to negative rates for the aerospace and chemical industries and financial institutions. It can be argued in fact that, after taking an average interest deduction into account as well as the other investment tax benefits, the effective tax rate for the average new investment is generally negative and therefore more beneficial than repeal of the corporate income tax.

Notwithstanding the reduction of the corporate tax burden, the effect of many of the changes made to Subchapter C by the 1981, 1982, and 1984 Acts is to strengthen the structure of the existing system of double taxation of corporate income. This undeniably is the effect of eliminating nonrecognition of income for distributions of property, expanding earnings and profits, and extending the accumulated earnings tax provisions; the changes in the treatment of acquisitions made in the 1982 Act were also consistent. Does this make sense?

However strongly one may favor the integration of corporate and shareholder income taxes, it is difficult to argue that integration should be effected by preserving *General Utilities* or through quirks in the definition of earnings and profits. On balance, therefore, it is unfair to object to what has happened to Subchapter C on the ground that the changes eliminate the "integration" of corporate and shareholder taxation that was in Subchapter C. The reduction in the corporate tax burden that accompanied these changes, however, had the effect of eliminating any strong constituency for serious integration proposals. The benefits of these proposals have traditionally been limited to taxpaying corporations. To the extent that a great many corporations pay little or no federal income tax, the pressure to integrate is removed.

Tax legislation since 1980, however, may be faulted on a number of grounds. First, the piecemeal approach to a repeal of *General Utilities* is not sensible. Imposing a tax at the corporate level on dividend distributions but leaving *General Utilities* in place in other situations defers distributions until *General Utilities* applies, as in, for example, a complete liquidation. A repeal of *General Utilities*, with or without relief, would eliminate the resulting distortion.

Another shortcoming has been the failure to come to grips directly with the treatment of pass-through entities and the extent to which they can be

used to disincorporate assets that would otherwise be held in regular corporations. The advantages of pass-through statutes are too great to believe that the new rules on corporate distributions will deter the formation of royalty trusts and the continued use of publicly-traded partnerships. The chance that congressional legislation will be able to deal with this phenomenon will diminish as the market significance, and thus the political power, of these entities grows. As it stands now, royalty trusts can be used to hold oil and gas and other mineral interests and eliminate corporate tax on oil and gas and other mineral income, as well as giving certificate holders the chance to recover their investment against ordinary income. Publicly-traded partnerships confer the same advantages so long as a section 754 election is available so that the price paid by new investors is reflected in their shares of partnership taxable income. The need to address this comprehensively will become even more acute if, as proposed by the Preliminary Report, section 337 is repealed and gain is recognized on the distribution of property in a liquidation of a corporation. The Treasury proposals made in late 1984 would handle this in the case of limited partnerships (and possibly trusts, as well) but the fate of those proposals is uncertain.

It is also unclear to what extent any consideration has been given to the practical effect of the new asset write-up rules on corporate acquisitions and mergers. Recapture of investment credit and ACRS and other deductions, if they must be paid, are an upfront cost, while the benefits of any write-up are ordinarily realized only over time through larger deductions for amortization, depletion, depreciation, and cost of goods sold. In equipment intensive businesses, therefore, it is unlikely that a section 338 election will be beneficial; and, conversely, the election will more likely be made when there are amortizable assets, such as life insurance in force or leases, that can be written up without any recapture. If the proposals in the Preliminary Report were adopted, a cost basis election might be unattractive for everyone, depending on the form of relief from *General Utilities*. But, until then, the section 338 rules will lead to quite different results, depending on the target corporation's business.

There is little evidence that this was understood at the time the 1982 Act was passed. The problem is the unevenness of recapture provisions (and of the related "tax benefit" doctrine). Why should it be more advantageous to write up the assets of a life insurance company than of a manufacturing company? The changes made by the 1982 Act will also increase the pressure to amortize intangibles (in effect, they will narrow what is treated as "goodwill"), and some of this is already apparent in the positions being taken with respect to acquisitions of banks.⁷¹ The uneven operation of the recapture rules might be eliminated if the acquisition proposals in the Preliminary Report were adopted, depending on the form of relief from the

71. See, e.g., *Southern Bancorporation, Inc. v. United States*, 732 F.2d 374 (4th Cir. 1984); *Banc One Corp.*, 84 T.C. ¶ 84.35 (1985); *Midlantic Nat'l Bank/Merchants*, 52 T.C.M. (P-H) ¶ 83,581 (1983).

repeal of *General Utilities*, but (as noted above) there might then never be an incentive to elect a cost basis in a corporate acquisition. Is that desirable? Again, there is no evidence that this has been a factor in the development of those proposals.

A strong system of double taxation of corporate income also puts pressure on the distinction between debt and equity, at least for taxable corporations. And the failure of the Treasury Department to develop acceptable rules under section 385 no doubt reflects the importance of shareholder debt as a way of reducing the corporate tax burden, although in many cases the proposed regulations were prepared to sacrifice corporate tax so long as the shareholder-creditors were appropriately taxed. The overwhelming importance of the interest deductions apparent from the surge of leveraged buyouts, which rely more on that deduction than on any asset write-ups, and from the sometimes unsuccessful effort to develop instruments (for example, "ARCN's" or adjustable rate convertible notes⁷²) which are perceived as equity for some purposes but treated as debt for tax purposes. Certainly none of the structural changes made by the 1981, 1982, or 1984 Acts reversed the bias towards financing with debt securities that generally inheres in a nonintegrated corporate tax (the main exception being the allowance of deductions for certain contributions and dividends paid in connection with ESOP's). Indeed, some of the changes in the 1984 Act (the elimination of so-called debt equity swaps, the restriction on the 85% dividends received deduction, and the allowance of a partial income exclusion to interest on loans to ESOP's) point the other way. Again, the Treasury proposals made in late 1984 would deal with this (principally by allowing a deduction for 50% of dividends paid out of taxable income) but the fate of those proposals is uncertain. And the choice of a dividends paid deduction, in lieu of a shareholder credit, as a means for integrating casts some doubt on the sincerity of the proposal.⁷³

There seems, finally, to have been only minimal consideration of the effect of many of these changes in the foreign area. The foreign tax credit effects of extending changes in Subchapter C to foreign operations is very significant, a point that seems largely to have been missed. Thus, a section 338 election, if made with respect to a foreign corporation, may be relevant only because it will eliminate existing earnings and profits and affect the earnings and profits of later years, and the "deemed paid" foreign tax credit will be calculated on this basis, notwithstanding that the foreign tax jurisdiction is unlikely to pay any attention to the election. The effect will be a distortion in the foreign tax credit that may in some cases benefit or hurt taxpayers. Direct changes to the

72. Rev. Rul. 83-98, 1983-2 C.B. 40.

73. The problem with the deduction, as opposed to the credit, is the limited ability to stem the revenue loss from dividends paid to tax exempt and treaty-country foreign shareholders. Are we really to believe that the Treasury would endorse an effective 22.5% rate for foreign subsidiaries of Netherlands corporations? The discussion of this in the Treasury proposals seems intended to bolster the U.S. negotiating position in treaty negotiations. See the discussion in 2 TREAS. REPORT, *supra* note 4, at 142-43.

definition of earnings and profits have the same effect. It would make more sense to approach this area with the foreign tax credit in mind and at least to consider a water's edge approach to many of the changes made in Subchapter C.

Finally, the problem of net operating loss and other carryovers has expanded and remains unresolved. We are still without workable rules on net operating loss and other carryovers more than eight years after Congress first began to revise those rules in the Tax Reform Act of 1976. The Preliminary Report and the hearings on its carryover proposals, both in the Senate and the House, have so far produced nothing concrete. This is so, notwithstanding the increase in loss and credit carryovers from the changes in depreciation in the 1981 Act. This has led to new pressures, many of which will not be solved by the adoption of the proposals in the Preliminary Report. Examples of the new pressures are the use of partnerships with loss partners in leveraged buyouts and the use of losses to convert taxable interest income into dividends eligible for the 85% dividends received deduction.