REPORT #522

TAX SECTION

New York State Bar Association

Report On H.R. 3838 Provisions Relating to General Utilities Repeal

April 1986

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Attached letter dated 4/15/86 enclosing Report on H.R. 3838 Provisions Relating to General Utilities Repeal sent to the following:

The Honorable Dan Rostenkowski
cc: The Hon. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

J. Roger Mentz, Esq.
Assistant Secretary (Tax Policy)
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April 15, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

I enclose a report of the Tax Section of the New York State Bar Association, commenting on those provisions of H.R. 3838 which relate to repeal of the General Utilities principle.

In summary, this report reflects the following conclusions:

(1) On balance, the Executive Committee of the Tax Section of the New York State Bar Association favors repeal of the General Utilities principle, although a substantial minority of its members do not favor its repeal.

(2) We strongly urge that repeal of the General Utilities doctrine only be enacted as part of an entire Subchapter C revision and made effective at the same time.

(3) Without dissent, we oppose repeal of General Utilities without, as a minimum, enacting amendments to Subchapter C that would permit cash sales of corporate assets to be treated on a carryover basis without recognition of gain.

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(4) Without dissent, we believe that some relief measure is appropriate for certain types of assets. There is not sufficient unanimity in the group, however, to endorse any specific relief proposal. Accordingly, the advantages and disadvantages of various possible relief provisions are set out in the report.

I hope that the report's comments on those provisions of H.R. 3838 relating to repeal of the General Utilities principle will prove helpful.

Sincerely,

Richard G. Cohen

Enclosure
cc: The Honorable John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

REPORT #522

NEK YORK STATE BAR ASSOCIATION

TAX SECTION

Report On H.R. 3838 Provisions Relating to *General Utilities* Repeal

April 1986

I. Summary

This report[1] discusses Sections 331-335 of the proposed Tax Reform Act of 1985 (H.R. 3838, the "House Bill"), relating to the recognition of gain and loss on distributions and sales of property by corporations in liquidation, and the equivalent provisions of Senator Packwood's proposal contained in "Tax Reform Proposals in Connection with Committee on Finance Markup," prepared by the Joint Committee on Taxation Staff ("Packwood proposal")[2].

The House Bill would repeal, with limited exceptions, the Last vestiges of what has come to be known as the General Utilities principle: that a corporation that distributes appreciated property with respect to its stock does not recognize gain. Under present law, corporations generally recognize gain. When distributing appreciated property with respect to their stock in nonliquidating distributions. They do not generally recognize gain on distributions in complete liquidation (or in sales of property in connection with complete liquidations), with important exceptions.

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[1] This report was prepared by Peter L. Faber for the Reorganizations Committee of the Tax Section. Helpful comments were received from M. Bernard Aidinoff, Martin B. Amdur, Renato Beghe, William L. Burke, Herbert L. Camp, Richard G. Cohen, Dale S. Collinson, James S. Eustice, Arthur A. Feder, Charles E. Heming, Robert A. Jacobs, E2- war2 D. Kleinbard, Robert J. Levinsohn, James A. Levitan, Richard O. Loengard, Jr., Robert N. Macris, Ronald A. Morris, Sidney I. Roberts, Donald Schapiro, Ruth G. Schapiro, Michael L. Schler, Eugene L. Vogel, Philip S. Winterer, George E. Zeitlin, and Victor Zonana.

[2] Joint Committee on Taxation, Tax Reform Proposals in Connection with Committee on Finance Markup (JCS-8-86), March 18, 1986, pp. 53-56.

Corporations do not recognize loss on distributions with respect to their stock.

The House Bill would require corporations to recognize gain and loss on liquidating distributions and sales, effecting a major change in the way corporations and their shareholders are taxed. The Packwood Proposal would follow the House Bill in requiring recognition of gain or loss in corporate liquidations but would differ from the House Bill on the following major points:

(a) The relief provisions in the Packwood Proposal differ from those in the House Bill;

(b) The effective date of the Packwood Proposal is moved from November 20, 1985 to March 1, 1986; and

(c) The Packwood Proposal is coupled with significant changes in other Subchapter C rules, most notably in those relating to the ability to elect to treat certain cash sales of corporate assets as providing no step-up in basis and no gain to the seller.

This report contains the following conclusions:

(1) On balance, the Executive Committee of the Tax Section of the New York State Bar Association favors repeal of the General Utilities principle, although a substantial minority of its members do not favor its repeal.

(2) We strongly urge that repeal of the _General Utilities_ doctrine only be enacted as par; of an entire Subchapter C revision and made effective at the same time.

(3) Without dissent, our group opposes repeal of _General Utilities_ without, as a minimum, enacting amendments to Subchapter C that would permit cash sales of corporate assets to be treated on a carryover basis without recognition of gain.

(4) Without dissent, our group believes that some relief measure is appropriate for certain types of assets. There is not sufficient unanimity in the group, however, to endorse any specific relief proposal. Accordingly, the advantages and disadvantages of various possible relief provisions are set out later in this report.

II. Introduction

Under present law, a corporate business can be sold at the cost of a single capital gains tax imposed at the shareholder level, although corporate level tax is imposed with respect to depreciation recapture and similar items. Thus, the overall tax rate imposed on sales of corporate businesses with individual shareholders is 20%.

Under the House Bill's approach, the tax cost, using present razes and ignoring ordinary income items, would be increased to 42.4%; using H.R. 3838 rates, the comparable tax cost woul6 be increased to 50.1%.[3] These are major changes in the tax cost of selling a business and would require corporations and their advisors to rethink the process by which corporate businesses are bought and sold and to reevaluate the manner in which businesses are organized in the first place.

The imposition of a double tax on the sale of a business could influence decisions as to whether to incorporate a new business or, if it is incorporated, as to whether to make an S election. Although many other factors influence decisions as to whether to incorporate

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[3] Assuming no changes other than a repeal of General Utilities, a 28% tax would be imposed at the corporate level. The after-tax proceeds would be subject to a further 20% tax at the shareholder level. Under the rates set forth in the House Bill, the corporate level tax would be 36% and the individual shareholder level tax would be 22%, producing a total tax of 50.1%. These rates do not take into account the extent to which depreciation recapture and similar items may result in the imposition of tax at ordinary income rates.

a business, including the desirability of limited liability and the possibility of eventually selling the business tax-free in a corporate reorganization, the tax cost of a taxable sale, even if it may occur many years in the future, cannot be ignored by careful taxpayers and their advisor.

A change of this magnitude should be enacted only after careful consideration of its implications and of its effect on the entire structure of Subchapter C. The General Utilities principle does not stand in isolation. It affects virtually every provision of the law relating to the taxation of corporations and their shareholders. Several serious studies in recent years, notably those by the American Law Institute and the Senate Finance Committee Staff, have concluded that General Utilities should be repealed but only in the context of a thorough overhaul of Subchapter C; these studies have not recommended that General Utilities repeal be addresses in isolation.

Hearings were held before the Senate Finance Committee on September 30, 1985, concerning the Senate Finance Committee Staff's proposed revisions of Subchapter c[4]. Nevertheless, many in the tax community were surprised to learn That General Utilities repeal was being proposed for enactment at this time.

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[4] The Subchapter C Revision Act of 1985, S. Prt. 99-47, 99th Cong., 1st Sess. (1985), referred to below as the "Staff Report."

On November 20, 1985, the House Committee on Ways and Means announced that its bill would include a provision for the repeal of General Utilities, effective on the date of announcement, apparently tied in with the Committee's decision to continue certain oil and gas industry tax incentives. However, General Utilities repeal would not be limited to the oil and gas industry. It would affect every incorporated business in the country from the largest Fortune 100 company to the "mom-and-pop" grocery store.

As the following discussion reveals, the House Bill's repeal of General Utilities raises important technical issues and could be substantially improved. Even if one agrees that its stated objective is desirable, the House Bill accomplishes that objective poorly.

The Tax Section believes that Subchapter C needs reform. Although we do not oppose the repeal of General Utilities at this time, for the reasons stated below, we urge that General Utilities repeal be considered as part of a more comprehensive review of Subchapter C as exemplified by Senator Packwood's proposals.

III. The Problem

A general principle that appears throughout the Internal Revenue Code is that the transferee of appreciated property receives a new basis in the property reflecting his cost only if the transferor recognizes gain. Thus, the price thus the parties to a corporate reorganization pay for tax-free treatment for the transferors is that the transferee takes a carryover basis even though the properties' value at the time of the transfer exceeds that basis.[5]

The General Utilities principle embodies another exception to the general rule. If a corporation distributes appreciated property in complete liquidation, present law provides that the shareholders receive a basis reflecting the property's fair market value or the date of distribution,[6] yet the corporation recognizes no gain except for recapture items.[7] Thus as a result of such a liquidation, the appreciation in the value of the corporation's assets is never taxed. Although the shareholders are taxed on the distribution, they may or

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5 A conspicuous exception to this principle is the rule of I.R.C. 5 1014 that properly transferred at death receives a new basis equal to its fair market value at death with no concomitant recognition of gain by the decedent or his estate. A stepped-up basis at death made little sense to many commentators and it was replaced in the Tax Reform Act of 1976 with a carryover basis provision, but the administrative and political problems associated with carryover basis were such that a stepped-up basis system was restore5 a few years later without carryover basis ever becoming effective except for a short period on an optional basis.

6 IRC $ 334 (a).

7 IRC $ 336.

may not realize gain depending on their basis in their stock.

If instead of distributing its assets in kind, the corporation sells them and distributes the proceeds, Section 337 provides that the corporation recognizes no gain, except for the same types of recapture liabilities that are imposed on a corporation distributing assets in liquidation, although the buyer receives a basis reflecting the assets' fair market values on the date of the purchase. The shareholders are taxed on any gain that they realize when they receive a liquidating distribution and the net effect of the transaction is the same as if the corporation had distributed its assets in liquidation and the shareholders had then sold them.

If, instead, the shareholders of the corporation sell their stock to another corporation and the buyer makes a Section 338 election, the buyer receives a stepped-up basis for the target's assets at the cost of only the same recapture liabilities. Thus, present law provides, in general, that appreciation in value of corporate assets escapes corporate level tax when the corporate business is sold or liquidated.

Although the _General Utilities_ problem has sometimes been described as one of whether corporations should recognize gain when they distribute property with respect to their stock, this is a misnomer. The gap in the statutory scheme results not from the absence of gain recognition in isolation but from its coupling with a stepped-up basis. If the recipient of corporate property

in a liquidation or liquidating sale did not receive a stepped-up basis for the property, there would be no tax avoidance and hence no problem. The General Utilities problem arises from the failure of the gain recognition rules to parallel the basis adjustment rules.

Before the enactment of the Internal Revenue Code of 1954, the statutory law did not directly address the treatment of corporations making distributions with respect to their stock. General Utilities & Operating Co. v. Helvering[8] had been interpreted as standing for the general proposition that a corporate distribution of appreciated property was not a recognition event to the distributing corporation and this principle was incorporated in statutory language when the 1954 Code was adopted.

Having codified the General Utilities principle, Congress later began to chip away at it. As imaginative tax practitioners developed new ways to take advantage of the stepped-up basis for corporate assets without the payment of the corporate tax, Congress reacted by cutting off specific manifestations of the principle. For example, in 1969, Congress enacted Section 311(d) providing for a recognition of gain by corporations distributing appreciated property in redemption of their stock, subject to certain exceptions.

In the Tax Equity and Fiscal Responsibility Act of 1962 ("TEFRA"), Congress responded to widespread publicity given to corporate take-overs that had used

[8] 296 U.S. 200 (1935).

distributions of appreciated property in stock redemptions and partial liquidations to obtain a stepped-up basis by providing that those transactions would generally result in recognition of gain by the distributing corporation. In the Tax Reform Act of 1984, Congress responded to publicity given to distributions of marketable securities as dividends by providing that current distributions of property by corporations would henceforth be subject to gain recognition at the corporate level.

Under present law, distributions of corporate property as dividends and current returns of capital and in redemptions and partial liquidations generally subject the corporation to tax on any appreciation, although loss is not recognized. There are many exceptions to the rule designed to provide relief for certain transactions (*e.g.*, Section 303 redemptions and distributions involving certain shareholders of closely-held corporations), but the *General Utilities* principle has been effectively repealed for all transactions except complete liquidations. The issues now before the Congress are whether the final nail should be driven in the *General Utilities* coffin and, if so, what relief should be afforded.

IV. Previous Studies

In 1974, the American Law Institute began a study of the taxation of corporations and shareholders. Over the next six years, the ALI reporter, Professor William D. Andrews of the Harvard Law School, met regularly with a small group of consultants and a larger group of advisors to develop a comprehensive series of proposals to govern the taxation of corporations and shareholders. These proposals were adopted by the ALI in 1980 and published in 1982.[9]

The ALI project focused initially on the treatment of corporate acquisitions. It noted that under existing law acquisitions were subject-to a variety of rules, not all of them internally consistent, depending on the form of the transaction. The ALI Report noted that acquisitions were generally taxes under one of two regimes. Tax-free treatment for the sellers and carryover basis for the buyer was generally available only if the transaction qualified as a "reorganization" under the complex definition set forth in section 368. The Technical rules for qualification for transactions that were economically similar but formally different varied considerably, leaving many technical traps that could prevent tax-free treatment for unsophisticated or careless taxpayers. The rules applicable to taxable transactions were not quite as complex, but the ALI Report noted that they offered buyers the opportunity to

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[9] American Law Institute, Federal income Tax Project Subchapter C Proposals on Corporate Acquisitions and Dispositions (1982), referred to as the "ALI Report."

obtain a stepped-up basis in the purchased assets without a corresponding corporate level recognition of gain.

The ALI Report recommended comprehensive changes to the manner in which corporate acquisitions were taxed. Acquisitions were divided into two general categories: cost basis and carryover basis transactions. The corporate parties were given the right to elect whether to take cost or carryover basis treatment. In general, this election was available regardless of whether the transaction took the form of an acquisition of stock or assets and regardless of the nature of the consideration. Thus, the possibility that the desired tax treatment of the transaction would not be available because of the failure to meet some minute technical requirement was minimized.

In a carryover basis transaction, the target corporation's assets retained their old basis and tax was not imposed with respect to appreciation in assets. In a cost basis transaction, the target's assets took a fair market value basis at the price of full recognition of the target's gain, with an exception for goodwill and going concern value. The ALI noted that, since goodwill and going concern value could neither be deducted nor amortized by the buyer, they would have no effect on the production of taxable income from the business to which they related and the imposition of a corporate level tax was therefore not needed to prevent tax avoidance.[10] Shareholder gain recognition was made dependent or, the

[10] ALI Report, page 121.

consideration received by the particular shareholder, without regard to the treatment of the transaction at the corporate level or the consideration received by the other shareholders. A shareholder receiving stock of the acquiring corporation or its parent was not taxed; a shareholder receiving other property was.

The ALI examined the General Utilities principle and concluded that it was "too far out of harmony with too many other aspects of the tax treatment of corporate transactions and profits" to remain in the law.[11] The ALI noted that the nonrecognition of corporate gain in connection with distribution and liquidating sales of property was inconsistent with the treatment of sales of property by the corporation in the ordinary course of Business and in circumstances other than in the context of a complete liquidation. Those anomalies had led corporations and their shareholders to devise artificial schemes to take advantage of the General Utilities rule, which, in turn, prompted Congress to devise complex ways of stopping these abuses, such as the collapsible corporation provisions.[12] The ALI therefore recommended that the General Utilities principle be repealed and that corporations be required to recognize gain on substantially all cost basis distributions or sales of property with the exception for goodwill and going concern value noted above.

[11] ALI Report, page 104.

[12] IRC $ 341.

The ALI proposed limited relief from the double tax burden resulting from the repeal of General Utilities in the case of liquidating sales and distributions, Recognizing that relief from the double tax was philosophically inconsistent with its general approach, the ALI nevertheless recommended that shareholders receiving distributions in a complete liquidation be allowed a credit for their shares of the corporation's liquidating capital gain tax.[13] This tax was defined as the corporation's tax liability resulting from gains from dispositions of capital assets and Section 1231 assets that had been held by the corporation for at least five years. The five-year holding period did not apply to gain realized on the sale of goodwill and similar intangibles that the corporation had chosen to recognize.

The ALI addressed the General Utilities problem in the context of its study of corporate acquisitions. Although the General Utilities principle has, generally been expressed in terms of a rule applicable to distributions of corporate property, in practice its most frequent manifestation appears in the context of sales of businesses. Corporate liquidations in kind (other than one-month liquidations under Section 333, in which a basis step-up is generally not available because the assets take the basis of the shareholders in their stock, with certain adjustments) are relatively uncommon. Although the ALI proposals addressed the treatment of non-liquidating distributions, and, indeed, they had to

[13] ALI Report, pages 134-141.

do so to avoid retaining the inconsistency of existing law in a reversed form, they did not approach the General Utilities problem as an isolated phenomenon bur, instead, properly viewed it in the business context in which it normally appeared.

The next major study of General Utilities was under-taken by the Senate Finance Committee Staff later in the same year in which the ALI Report was published. On October 28, i982, Senator Bob Dole, then Chairman of the Senate Finance Committee, announced that he had directed the Committee's Staff, with the assistance of the Staff of the Joint Committee on Taxation, to undertake a study of the taxation of corporations and shareholders and to report its recommendations to the Committee. Noting that TEFRA, passed earlier that year, had made "major strides toward preventing unintended corporate tax benefits to be realized by aggressive tax planners," Senator Dole said that existing law still contained possibilities for abuse and was unduly complex. In particular, Senator Dole directed the Staff to review the ALI Report and recent proposals of the Section of Taxation of the American Bar Association.[14]

The Staff formed a small advisory group of private practitioners and academicians and met with them regularly over a two-year period. On September 22, 1983, the Staff released a preliminary report containing recommendations relating to the taxation of corporate

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[14] The ABA Tax Section proposals related to the definition of reorganizations and did not address the General Utilities problem. See ABA Section of Taxation, Committee on Corporate Stockholder Relationships, Tax Section Recommendation No. 1981-5, 34 Tax Lawyer 1386 (1981).

acquisitions and other aspects of corporate-shareholder taxation.[15] A hearing was held on the proposals the next month and, based on the hearing and other comments that it received, the Staff resumed its deliberations. Other meetings were held with the outside advisors and a final report was released in May, 1985.[16] The Staff Report included statutory language as well as an explanation of the provisions.

Although the Staff Report addressed many issues involving the taxation of corporations and shareholders, its principal focus related to the taxation of corporate acquisitions. The Staff Report adopted the general approach of the ALI Report. A regime was proposed in which the corporate parties to a transaction could elect the corporate level tax treatment without regard to the transaction's form. The choices were basically the same as those available under the ALI Report.

Transactions were divided into cost basis and carryover basis transactions. In cost basis transactions, the target's assets took a new basis equal to the buyer's cost or their fair market value and the target recognized gain on all appreciation, not just on recapture items. In a carryover basis transaction, the target's assets kept their old basis and the target did not recognize gain.

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[15] Staff of the Senate Committee on Finance, "The Reform and Simplification of the Income Taxation of Corporations," S. Prt No. 98-95, 98th Cong., 1st Sess. (1983) (the "Staff Preliminary Report").

[16] Staff of the Senate Committee on Finance, "The Subchapter C Revision Act of 1985," S. Prt No. 99-47, 99th Cong., 1st Sess. (1985) (the "Staff Report").

The Staff Report followed the ALI Report in separating shareholder level tax consequences from corporate level tax consequences. A shareholder who received only stock in exchange for his or her stock in the target company would not be taxed on the realized gain, regardless of the nature of the consideration received by the other shareholders or the characterization of the transaction at the corporate level.

The Staff Report also concluded that General Utilities should be repealed. Although some of the witnesses at the hearing had General Utilities repeal, the Staff agreed with the Treasury Department that allowing an elective step-up in basis by the corporate parties without corporate level tax would significantly reduce the tax base.[17]

[17] Staff Report, page 59.

The Staff decided to provide relief from the double tax for liquidating distributions and sales. It did so by providing a reduction of tax at the shareholder level through an increase in each shareholder's basis in his stock reflecting his share of the corporation's tax on capital and Section 1231 assets that had been held for more than five years. The relief vas made available only for small businesses, defined as those with a value of $1,000,000 or less. Relief was phased out for larger corporations and disappeared for corporations with a value of more than $2,000,000. In addition, the Staff Report allowed the shareholders of corporations liquidating in kind to defer shareholder level tax with respect to any property distributed in the liquidation except for cash and marketable securities, paralleling to some extent the treatment afforded by Section 333 of present law.

Finally, the Staff Report, as did the ALI Report, allowed the corporate parties to elect carryover basis treatment for goodwill and other unamortizable intangibles. The Staff Report would repeal the collapsible corporation rules. The consistency rules of Section 338 would be substantially repealed by the Staff Report, although they would be retained to a reduced extent in order to impose a regime of corporation-by-corporation consistency.

The Staff, as did the ALI, addressed the General Utilities problem as part of a comprehensive review of the tax treatment of corporate acquisitions. Its proposals, developed in concert with tax practitioners and academicians, reflected a thoughtful attempt to address and resolve the problems raised by the repeal of General Utilities in its Subchapter C setting.

A hearing on the Staff's proposals was held on September 30, 1985. Once again, different views were expressed on the wisdom of General Utilities repeal, indicating a lack of consensus among professional tax advisors.

The Staff's basic proposals were included in the Packwood Proposal.

An American Bar Association Section of Taxation Task Force addressed the question of General Utilities repeal in connection with the Section's review of the Staff Preliminary Report. The Task Force generally favored repeal, with relief to be provided by exemption from the corporate level tax for gain attributable to long-held capital and Section 1231 assets.[18] The Task Force was by no means unanimous in this conclusion, however, and a minority report opposed repeal.

Thus, when the House Ways and Means Committee announced its proposals to repeal General Utilities on November 20, 1985, it can fairly be said that it was

[18] ABA Task Force Report, “Income Taxation of Corporations Making Distributions with Respect to their Stock,” 37 Tax Lawyer 625 (1984).

addressing in isolation an issue that had generally been viewed as part of a much larger problem.[19]

[19] In addition to these formal studies, the tax literature contains many articles discussing the General Utilities principle. The majority of commentators have favored repeal, but there is by no means a consensus on the issue. Moreover, although most studies have recommended some form of mitigation of the double tax with respect to liquidating distributions and sales, the form that mitigation should take has been hotly disputed. A partial list includes the following: Levis, "A Proposed New Treatment for Corporate Distributions and Sales in Liquidation," House Committee on Ways and Means, 3 Tax Revision Compendium 1643 (1959); Block, "Liquidations Before and After Repeal of General Utilities," 21 Harv. J. on Legis. 307 (1984); Blum, "Taxing Transfers of Incorporated Businesses: A Proposal for Improvement," 52 Taxes 516 (1974); Clark, "The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform;" 87 Yale L. J. 90 (1977); Beck, "Distributions in Kind in Corporate Liquidations: A Defense of General Utilities," 38 Tax Lawyer 663 (1985); Shube, "corporate Income or Loss on Distribution of Property: An Analysis of General Utilities," 12 J. of Corp. Tax. 3 (1985); Wolfman, "Corporate Distributions of property: The case for Repeal of the General Utilities Doctrine," 22 San Diego L. Rev. 81 (1985); Nolan "Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures," 22 San Diego L. Rev. 97 (1985).

V. Should General Utilities be Repealed?

The arguments for and against General Utilities repeal with respect to liquidating sales and distributions have been exhaustively discussed elsewhere,[20] and will not be repeated here except in summary form.

Proponents of repeal argue that the General Utilities principle creates a gap in the statute by allowing a step-up in basis for the buyer without a corresponding recognition of gain by the selling corporation. This inconsistency has led to complexities such as the collapsible corporation rules and the Section 338 consistency rules that could be eliminated if General Utilities were repealed.

The essence of most of the arguments in favor of repeal is that the General Utilities principle is inconsistent with an unintegrated system based on separate taxation of corporations and shareholders. The inconsistency produces strains on the system as taxpayers try to arrange their affairs to take advantage of the single-tax part of the system (e.g., by delaying sales of property until liquidation) and to avoid being subjected to the double-tax part of the system.

Opponents of repeal have argued that the present system has evolve6 based on an assumption that corporate

[20] See the studies and articles discussed and cited in Section IV of this report.

businesses could be sold at the cost of a single-level tax and that it would be harsh suddenly to replace that system with one in which a full double tax was imposed. It has been suggested that some businesses were incorporated in the first place because people assumed that the eventual sale of the business would be governed by the present system. It has also been suggested that repeal of General Utilities would create such a significant tax disincentive to incorporation that businesses that should be incorporated for non-tax reasons would be operated as partnerships or sole proprietorships in order to avoid the harsh tax consequences of a sale.

Most of the arguments in favor of repeal proceed from the basic premise that a tax system that imposes tax on current operations at both the corporate and shareholder levels should treat liquidation transactions in the same way. The arguments against repeal are similar to the arguments frequently advanced against retroactive tax legislation.[21] The argument runs that it would be unfair to impose a double-tax regime on people who have relied on a single-tax regime in arranging their business affairs. The proponents of repeal have made some concessions in this direction by generally agreeing to some measure of relief from the double tax, although it appears that these concessions have been made primarily in response to perceived political realities.

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[21] See NYSBA Tax Section, "Effective Dates of Tax Reform Legislation," Tax Notes (March 3, 19861), page 853.

The issue as t o whether General Utilities should be repealed is a close one. On balance, the Tax Section supports repeal of the General Utilities principle, although our members are by no means unanimous on the issue.[22] Nevertheless, we strongly believe that Sections 331-335 of the House Bill should be modified, for the technical and policy reasons discussed below, and we oppose any General Utilities repeal unless other Subchapter C changes are made with the same effective date. We favor relief from the double tax in some circumstances, but there is not sufficient unanimity among our members as to the type or amount of relief for us to make a recommendation in this regard.

General Utilities does not exist in a vacuum, and we believe that General Utilities should not be repealed without at least some Subchapter C reform. We would strongly favor coupling repeal of General Utilities with a complete reworking of Subchapter C.

As an absolute minimum, we believe that carryover basis asset acquisitions should be permitted as part of any repeal of General Utilities. If General Utilities is repealed, whenever the target corporation owns appreciated assess the parties will probably want to effect a carryover basis (non-recognition of gain)

[22] The question of whether General Utilities should be repealed involves economic as well as tax policy issues. The question of repeal is inextricably bound to judgments as to the proper tax impact on sales of corporate businesses. The Tax Section does not ordinarily express views on economic issues. Our support for General Utilities repeal on tax policy grounds should not be viewed as the expression of an opinion as to the

transaction. Under the Packwood Proposal, that result could be achieved in either a stock or an asset acquisition as long as a carryover basis treatment was elected. Under the House Bill, however, the only means of effectively avoiding double tax would be to effect a stock, rather than an asset, acquisition. Practically, a stock acquisition may not be possible or desirable. Frequently, it is difficult to purchase or otherwise acquire all of the target corporation's stock because not all of the target's shareholders can be persuaded to sell.[23] Moreover, many purchasers are unwilling (and advisedly so) to purchase stock with its attendant liabilities -- known and unknown. Therefore, we believe that the repeal of General Utilities should be accompanied at a minimum by provisions allowing sales of assets with a carryover basis.

If Congress is concerned about the revenue that might be lost if General Utilities were not repealed until the enactment of Subchapter C reform, less sweeping alternatives are available. It might, for example, repeal (or limit, by imposing a partial tax) the bulk sale of inventory exception in Section 337(b)(2) of the Code, which represents a major and arguably unjustified manifestation of the General Utilities principle in present law.

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appropriate tax burden to be borne by participants in corporate transactions.

[23] Although not always simple, a cash reverse subsidiary merger could often be used to acquire all of the stock of the target corporation.

VI. Relief From Double Taxation

A. Need for Relief

Complete repeal of the General Utilities principle would result in a full tax on the appreciation of corporate assets at the corporate level and a tax at the shareholder level on the sale of stock or liquidation of the corporation. As indicated above, the combined tax burden under present rates (excluding refinements such as depreciation recapture and the alternative minimum tax) would be 42.4%; under the House Bill rates, the combined burden would be 50.1%. This would represent a substantial increase in the tax cost of selling a business.

Moreover, such a radical change in the law would destroy the expectations of investors who over a substantial period of time have come to rely upon the continuation of existing law in evalustin5 the tax impact on a possible sale of a business. Since the General Utilities principle was specifically enacted by Congress in 1954 and has continued in the law for over 30 years, these expectations seem reasonable. While the right of the buyer and seller to agree on a carryover basis might mitigate the double tax if Subchapter C reform such as that embodied in the Packwood Proposal is adopted, the impact of electing a carryover basis would surely be felt in the price available to the seller.

Furthermore, the Tax Section notes that the propose5 repeal of General Utilities in both the House Bill and the Packwood Proposal is not combined with any significant degree of integration of the corporate and shareholder level taxes. While the Section is advocating neither retention of General Utilities nor integration of the corporate and individual income tax, we are concerned that the absence of both would produce an unduly heavy tax bur6en on the liquidation of a business.

In view of the foregoing, the Section recommends relief from the full impact of the repeal of General Utilities. In doing so, we recognize that such relief, when coupled with repeal of the anti-selectivity provisions of Section 338, might prove more beneficial to some taxpayers than the provisions of present law, but, for the reasons given above, we believe that relief is appropriate.

B. Transitional Relief

Such relief could take the form of transitional rules, which could either continue the application of General Utilities for some time in the future (either in its current form or some modified version) or limit the repeal of the General Utilities doctrine to appreciation in assets after a specified date. We are concerned, however, that the first of these approaches sooner or later would force liquidation of businesses to come within the "grandfather" provision, even though the shareholders would prefer not to sell. The second alternative would be difficult, if not impossible, to

administer and could be expected to lead to constant disputes about values for years into the future. While these might be avoided by providing that gains shall be prorated between the holding period before the effective date and the holding period thereafter, this would have a negative short term revenue impact. The Senate Finance Committee Staff's Preliminary Report provided for a phase-in of the corporate level tax. This was abandoned in the Final Report, but we believe that the idea has merit and should be reconsidered.

C. Permanent Relief

Although transitional relief should be considered, we believe that permanent relief is also called for.

Many of the proposals to repeal General Utilities have been coupled with recommendations for relief from the double tax. No consensus has emerged as to the method to be adopted, and there is no consensus on this issue among our members. We therefore discuss some of these methods below without making a recommendation as to which should be adopted.

The ALI Report would provide a credit for shareholders against the tax that would otherwise be imposed on liquidating distributions. The credit would equal each shareholder's share of the corporate level tax on long-held capital and Section 1231 assets. No relief would be given for gains on ordinary income assets.

The Senate Finance Committee Staff followed one approach in its 1983 Preliminary Report and another approach in its 1965 final Report. The Preliminary Report viewed the relief problem as one of transition. It provided no permanent relief but phased in the corporate level tax over ten years. The 1985 Staff Report proposed a permanent relief measure solely for the benefit of small corporations, Shareholder level relief was provided through a basis adjustment for each shareholder's share of the corporate level tax attributable to long-held capital and Section 1231 assets. Full relief was provided for shareholders of corporations with a value of less than $1,000,000 and the basis adjustment was phased out and was eliminated with respect to shareholders of corporations with a value of more than $2,000,000. Substituted basis treatment was provided for liquidations in kind at the election of the shareholder.

Thus, for acquisitions, the 1985 Staff Report concluded that permanent relief should be granted only to rather small corporations and that larger corporations (including closely-held corporations) should be subject to the full double tax.

The American Bar Association Section of Taxation Task Force proposed relief from the corporate level tax with respect to sales and distributions in complete liquidation of long-held capital and Section 1231 assets. Relief was granted to all corporations, regardless of size.

The House Bill adopts a different approach, granting relief from the corporate Level tax for corporations to the extent that their stock is owned by individuals who have owned more than 10% of the corporation's stock for more than five years (thus tracking one of the exemptions from corporate level tax for stock redemptions). By basing the claim for relief on the existence of more than 10% shareholders but by granting it at the corporate level, the House Bill would give the economic benefits of relief to all shareholders, including those whose shareholdings did not give rise to the claim for relief in the first place. Relief would be granted only for corporations solely engaged in active business operations.

The Tax Section believes that any relief from the double tax should be available only with respect to capital gain-producing assets that had been held for a significant period of time. If the sale of property by the corporation would ordinarily result in ordinary income and if the buyer receives a step-up in basis on its purchase, the selling or distributing corporation should be required to recognize gain at ordinary income rates. A corporation in the business of selling widgets should not be able to avoid ordinary income treatment on inventory profits by selling all of its inventory to one buyer in one sale (as can now be done under Section 337) or by distributing the inventory to its shareholders in liquidation. Sven opponents of General Utilities repeal have generally agreed that corporate level gain

recognition should be required for ordinary income assets.[24]

The form of permanent relief that should be provided to liquidating sales and distributions has been the subject of considerable debate. The Staff Report indicates that testimony at the 1962 hearing was almost evenly divided between a shareholder credit and a corporate level exemption.[25]

The principal advantage of a corporate level exemption would be its simplicity. Individual shareholders would not be burdened with confusing 1099 forms explaining the operation of the credit mechanism (whether by express credit, as under the ALI Report, or basis adjustment, as under the Staff Report); all decisions would be made by the corporation's management and the only impact on the shareholders would be that they would get larger liquidating distribution checks of course, corporate level relief would mean that its benefits would pass through to all shareholders, including non taxpaying entities (e.g., pension, plans, charities, some foreign investors, taxpayers with offsetting losses) that would be relieve not only of a double tax but of a single tax as well. On the other hand, if the theory of relief is that the corporate tax should apply only to ordinary income assets it is hard to

[24] See, e.g., Nolan, "Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures," 22 San Diego L. Rev. 97, 98 (1985).

[25] Staff Report, page 64.

see why the presence of tax-exempt shareholders is relevant.

The Staff Report argued that corporate level exemption amounted to nothing more than a partial repeal of General Utilities. The Staff felt that corporate level exemption would present many of the same problems that an incomplete repeal of General Utilities would present. Thus, if a target corporation's assets consisted entirely of long-held capital assets, an acquiring corporation paying its own stock as consideration could get a stepped-up basis without any tax being paid by either the corporate seller or its shareholders. This example would obviously not apply to a regime in which cost basis treatment was available only to taxable purchases; it assumed that the rest of the Staff Report proposals relating to corporate acquisitions ha2 been adopted so that a step-up in basis would be available in a transaction in which the acquiring corporation's stock was the only consideration so that the target corporation shareholders were not taxed. It is not clear how the Staff would view a corporate level exemption if the acquisition proposals in general were not being adopted and if the only change involved General Utilities repeal. (We note that this is a further reason for not considering General Utilities repeal in isolation and for taking it up in the context of an overall review of the taxation of corporate acquisitions.)

The principal advantage of the shareholder credit[26] is that it would provide relief only where a double tax would otherwise be imposed. If the reason for relief is that an overall tax burden of 42.4% (or 50.1%) is too great to impose the sale of a corporate business, the shareholder credit insures that relief will be granted only with respect to shareholders who would in fact suffer the economic burden of a double tax if no relief were provided. Non taxpaying shareholders would not avoid the burden of taxation entirely and the integrity of the corporate level tax would be preserved.

If a corporation has more than one class of stock, the credit should be allocated among the shareholders in proportion to the extent to which they bear the economic burden of the corporate level tax. Thus, preferred shareholders should receive the credit only to the extent that the corporate tax reduces the amount to which they would otherwise be entitled on liquidation.

The shareholder credit approach is not without problems, however, and its theoretical appeal might be offset by practical problems in its implementation.

A mechanism would have to be developed to provide a bin3Sng determination as to the computation and allocation of the credit as part of the Internal Revenue Service's audit of the corporation; otherwise, the audits

[26] Similar results may be achieved through a Shareholder stock basis adjustment. See Staff Report, page 239, and proposed new Code S 1060.

of different shareholders could lead to different results.

Difficulties may arise on audit if the IRS finds that the tax attributable to the sale of qualified assets was overstated and correspondingly that the tax attributable to the sale of nonqualified assets was understated. Absent some special provision, this could lead in some cases to no additional tax liability for the corporation but merely excess credits for its shareholders. It might be a practical impossibility for the IRS to assert deficiencies against each of the individual shareholders.

A possible solution would be to levy the additional tax on the corporation. For example, if the sales price of the qualified assets was overstated and the sale price of inventory was understated, the corporation could be required to pay an additional tax equal to the appropriate rate of tax on the amount by which the inventory was undervalued; the shareholders would keep their credits. This would make the Treasury whole and, in fact, more than whole to the extent that some shareholders (e.g., charities and estates) would not be able to use the credit. While collection of tax from a liquidated corporation can be a problem, this problem can arise now in the case of a Section 337 transaction and is usually handled by transferring assets to a liquidating trust or by other means.

The effect of the shareholder credit approach on different types of transactions should be assessed.

The application of a shareholder credit mechanism when a corporation buys stock of a target from the target's shareholders and makes a Section 338 election could be complex. In theory, it seems appropriate to give the selling shareholders a credit against the tax just as they would receive such a credit if the target corporation sold its assets and liquidated. In principle, the tax consequences of the two transactions should be the same. Furthermore, this is so even though this credit is neither bargained for nor considered by the selling shareholders in agreeing to sell and depends on a separate election by the buyer to claim a step-up in basis. It seems inappropriate to give a refundable credit to the buyer that would have the effect of eliminating the corporate level tax on the transaction entirely, a more favorable result than if assets were sold.

Two additional complexities exist. First, it would seem that shares sold on the market should not be eligible for the credit even though the acquiring corporation might have been the purchaser of those particular shares; only shares tendered directly to the buyer or sold in a merger or other form of acquisitive transaction would qualify for the credit. This might make shareholders reluctant to sell to arbitrageurs, which could reduce trading in the stock and have an impact on its price.

Furthermore, the amount of the credit should not be determined on the basis of the total amount of the tax

divided by the total number of outstanding shares since they may include “nonrecently purchased stock”, as defined in Section 338(b)(6)(B). It seems that each selling shareholder should be entitled to the credit he would have gotten if all of the shares of the company had been acquired by the buyer at the shareholder's selling price (and was “recently purchased stock” within the meaning of Section 338(b)(6)(A)), provided that the total amount of all shareholders' credits does not exceed the Section 338 tax actually paid.

A further form of relief that night be considered would be to allow corporations to liquidate under a carryover basis regime. This would mirror at the corporation's death the carryover basis treatment that Sections 351 and 362 provide at its birth. This would avoid the imposition of tax on an event in which (unlike a sale) no cash is realized and the carryover basis would result in a deferral and not an avoidance of tax. Tracing the carryover basis through to the shareholders should not be an insurmountable problem. The corporation's earnings and profits might be taxed to the shareholders as a dividend, as is done under Section 333. A possible disadvantage of this approach would be that it might lead to disputes between taxpayers and the Internal Revenue Service as to whether sales of assets by the shareholders after liquidation should be imputed to the corporation, thus producing a tax at both the corporate and

shareholder levels instead of only a single shareholder level tax.[27]

[27] See Commissioner v. Court Holding Company, 324 U.S. 331 (1945); U.S. v. Cumberland Public Service Company, 338 U.S. 451 (1950).

VII. Analysis of the House Bill[28]

A. Substantive Provisions

The House Bill repeals General Utilities by providing as a general rule that: (i) gain or loss will be recognized to a corporation on the distribution of property in complete liquidation as if the property had been sold to the distribute at its fair market value, and (ii) corporate gain will be recognized on the sale of property in connection with a liquidation to the extent that gain would have been recognized had the property been distributed to the shareholders of the liquidating corporation. The House Bill provisions that address the General Utilities problem present technical difficulties that should be addressed.

Section 336(b) would except Section 332 liquidations of controlled subsidiaries from the general rule to the extent that property was distributed to an 80% corporate shareholder. If there were minority shareholders in a Section 332 liquidation, an amount of gain would be recognized equal to the percentage of the value of the corporation's stock represented by the stock of the minority shareholders. Because this tax would be imposed at the corporate level, its economic burden would be borne by the shareholders in proportion to their shareholdings. Thus, for example, if corporation P owned 91% of corporation S’s stock and the other 9% was owned by a group of individual shareholders, a Section 332 liquidation of S would result in corporate level

[28] This report contains no detailed analysis of the Packwood Proposal because statutory language is not available.

recognition of 9% of S's gain, but P, as the 91% shareholder, would effectively pay 91% of the tax. Moreover, the same result would occur even if all of the appreciation was in the assets distributed to the minority shareholders. Preferable approaches would be to exempt Section 332 liquidations entirely or to impose a corporate level tax and give the parent a credit for its share.

A further exception is provided for the distribution of certain capital gain assets in liquidation of an "active business corporation" where one or more shareholders hold "qualified stock." The definition of "qualified stock" for this purpose is the same as that applicable under Section 311(e)(1) pertaining stock redemptions. Under Section 311(e)(1), the shareholder must be other than a corporation and must have held at least 10% in value of the corporation's outstanding stock at all times during the lesser of the five-year period ending on the date of distribution or the period during which the corporation was in existence. Here, too, relief, although defined in terms of the existence of "good" shareholders, applies at the corporate level and benefits all shareholders. Thus, if 75% of a corporation's stock is owned by e large publicly-owned conglomerate and 25% has been owned by an individual for more than five years, 75% of the savings resulting from the reduced corporate level tax will benefit the conglomerate and only 25% will help the individual. If Congress concludes that the presence of more than 10% shareholders is the event that justifies relief from double tax, it would seem appropriate that

the relief mechanism give those shareholders the benefit through a shareholder level credit (or basis adjustment) and not apply at the corporate level.

The ownership test is determined under proposed Section 336(c)(3) on the date on which the plan of liquidation is adopted. Thus, it would apparently be possible to redeem some or all of the nonqualifying shares for cash before that date so as to increase the proportionate interests of the qualifying shareholders. The question of whether such redemptions should be linked to the plan of liquidation would create undesirable uncertainty and would lead to litigation.

The active business corporation exception applies to a Section 338 transaction If, as of the date on which the first stock purchase included in the qualified stock purchase was made, one or more shareholders held qualified stock in the corporation. Thus, it would appear that, if the one good shareholder sold his stock to a group of buyers the day after the first purchase of stock, when the buying corporation owned only 3% of the target's stock, the exception would still apply, even though on the date on which the rest of the stock was purchased 10 months later the good shareholder was long gone.

Section 336(c)(6) provides that nonrecognition under the active business test is “in addition” to nonrecognition under Section 336(b), relating to Section 332 liquidations. if applied literally, this could mean that the holdings of a parent corporation that bought

qualified stock from a minority shareholder for cash after the adoption of the plan of liquidation would be increased by those holdings for purposes of the Section 332 exception and those holdings would still qualify separately for the active business exception with the result that the qualified stock purchased by the parent corporation would be counted twice, leading to an undeserved benefit.

Under proposed Section 336(c)(5), this exception would be available only if substantially all the assets of the corporation consisted of the assets of one or more qualified businesses and no substantial part of the corporation's non-business assets were acquired In a Section 351 transaction or as a contribution to capital within the five years ending or the date of the completion of the liquidation. Here again, the definitions of “qualified business” and “nonbusiness asset” are imported from Section 311(e). A qualified business is a trade or business that was actively conducted throughout the five-year period ending on the date of the distribution and that was not acquired by any person within such period in a transaction in which gain or loss was recognized in whole or in part.

The phrase “substantially all” is once again imported from the Code provisions relating to stock redemptions, but no guidance as to its meaning is available under those provisions. Will the Internal Revenue Service apply a 70%-of-gross assets and 90%-of-net assets test as it has in issuing rulings under Section 368(a)(l)(C)? The courts have been considerably

less restrictive than the Service's advance ruling position. How will marketable securities held as a contingency reserve be treated? Aside from the difficulties of administering this test, there is a question as to the tax policy for limiting relief to "active business" corporations. If the problem addressed is that the imposition of the double tax system on corporations and shareholders is too harsh, that harshness would appear to be no less aggravated for investment assets than it is for active business assets.

The House Bill addresses the most overt manifestations of the General Utilities principle without addressing its side effects. Many present law provisions are needed only because of the General Utilities doctrine and could be eliminated if General Utilities were repealed. These include the collapsible corporation rules and the consistency rules of Section 338.[29] The ALI and Senate finance Committee Staff Reports would repeal the collapsible corporation rules, and we not with approval that the Packwood Proposal would do the same.

To prevent a "quickie" Subchapter S election to, avoid the double tax, Section 334 of the House Bill adds a new Section 1362(d)(4) that provides that, if a C corporation elects after November 19, 1985 to be an S corporation and liquidates within three years after the S election is effected, the S election will be terminated retroactively. On the other had if the corporation can

[29] In all events, the salutary rule of Section 338(h)(10) should be reserved and perhaps extended to cases in which the target does not file consolidated returns with its selling parent.

wait out the three years, this provision will not apply. If the sale of the corporation's business occurs within three years after making the S election, the corporation is likely to be subject to the corporate level capital gain tax of Section 1374, although this tax can be substantially reduced or avoided by using an installment sale.

The retroactive disallowance of an S election would not be limited to situations in which the election had made to avoid the double tax that would otherwise have been imposed because of the repeal of General Utilities. Whenever this election is terminated, all the shareholders would be required to file amended returns, even those shareholders who no longer own stock of the corporation. Basis adjustments would have to be made for shareholders who had sold their stock.

Proposed Section 1362(d)(4) seems like a harsh and complicated solution to a relatively simple problem. The Code already contains a provision designed to prevent one-shot S elections to avoid double taxation: Section 1374. Rather than retroactively disallow S elections, it would make more sense to amend Section 1374 to pick up the situation in which an S election is made to avoid the application of General Utilities repeal to an impending sale or liquidation. The Packwood Proposal's approach of limiting the extent to which the shareholders can increase the basis of their stock seems preferable to that of the House Bill.

Section 336(a) provides that gain recognition is determined as if the property were sold "to the distributee" at its fair market value. The amendment to Section 337 would impose a corporate level tax by treating the corporation's assets as if they had been distributed to its shareholders rather than sold to a third party. If depreciable property is distributed to an 80% shareholder in liquidation Section 1239 would impose ordinary income treatment on the corporation.

If the corporation is taxed at the same rates on capital gains and ordinary income, this would not be a problem. If corporate capital gains continue to be taxed at lower rates, however, this provision would seem unfair. I f corporate capital gains were still taxed at a preferred rate, a sale of depreciable property to an unrelated third party in a Section 337 transaction would apparently result in ordinary income to the corporation if it had an 80% shareholder, because new Section 357 would require the transaction to be taxes as if the corporation had distributed the property to its shareholders and it had then been sold by them.

The House Bill makes no exceptions to the corporate level tax for good will, going concern value, and other unamortizable intangibles. Such an exception is provided in both the ALI and Staff Reports and should be included in any General Utilities repeal. A stepped-up basis for these assets will not be applied to reduce corporate level tax on earnings from business operations and will produce a tax benefit only when the business is sold, at which time the intangible assets will presumably

qualify for relief from the double tax under whatever relief mechanism is adopted. A double tax on these assets is not needed to prevent tax avoidance and should not be imposed. The appropriate form of relief would be exemption from the corporate level tax.

Congress should consider providing an escape hatch similar to present Section 333, either permanently[30] or for a few years.[31] This would enable corporations that had been formed under the old regime and that had not accumulated substantial earnings and profits to liquidate without undue cost. A carryover or substituted basis could be provided. Although the House Bill does not repeal Section 333, its use under the House Bill could be catastrophic. If a corporation distributed appreciated property in a Section 333 liquidation, the recognized gains would increase its earnings and profits and the increase (less the resulting corporate level tax) would be taxed to the shareholders as ordinary income.

Congress should also consider exempting from the corporate level tax distributions of the stock of controlled subsidiaries, whether or not the transaction qualifies as a tax-free spin-off. Because the assets of

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[30] The permanent relief that Section 333 would provide may not be appropriate if no corporate level relief similar to present Section 337 is to be accorded long-held capital gain producing assets.

[31] A precedent for providing temporary relief exists in the personal holding company area. When the personal holding company rules were tightened in the Revenue Act of 1964, effective as of January 1, 1966, affected corporations were allowed to liquidate under favorable terms during 1966 but not thereafter. See former Code Section 339(g)(3), repealed by Section 1951(b)(6)(A) of the Tax Reform Act of 1976.

the distributed corporation would remain in corporate solution, imposition of tax on the distributing corporation would not seem to be necessary to preserve the integrity of the corporate level tax.[32]

There appears to be a typographical error in Section 336(e)(2). The reference to "subsection (b)" should be to "subsection (c)."

B. Effective Dates.

The House Bill's General Utilities repeal provisions would apply to most distributions or sales or exchanges after November 19, 1985 and Section 338 acquisitions for which the acquisition occurs after November 19, 1985.[33]

Section 335(b)(1) provides an exception for distribution or sales an6 exchanges made pursuant to a plan of liquidation adopted before November 20, 1985. Subsection (2) provides special rules for determining when a plan of liquidation was adopted.

One exception is made if before November 20, 1985, the target's board of directors adopted a resolution to solicit shareholder approval for a distribution or liquidating sale or the shareholders or board of directors have approved the transaction, but only if the plan of liquidation is adopted before January

[32] The "no tax" rule at the corporate level should be continues regardless of whether the distribution qualifies as tax-free to the receiving shareholders under Section 355.

[33] The Packwood Proposal would change the November 19, 1985 date to February 28, 1986.

1, 1988 and at least one sale or distribution pursuant to the plan was made before that date.

A second exception, is provided if, before November 20, 1985, there has been an offer to purchase a majority of the corporation's voting stock or its board of directors had adopted a resolution approving an acquisition or recommending its approval to the shareholders, but only if the sale or distributes is pursuant to or was contemplated by the terms of the offer or resolution, a plan of liquidation is adopted before January 1, 1988, and there was at least one sale or distribution before January 1, 1988.

A final exception is provided if a ruling request was submitted to the Secretary of the Treasury for a Section 336 or a Section 337 transaction and a plan of complete liquidation was adopted and at least one sale or distribution pursuant to the plan occurs before the later of January l, 1988 or ninety days after the date on which the ruling is issued.[34]

The transitional rules provide that a Section 338 election will be treated as the adoption of a plan of complete liquidation.

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[34] This last exception does not provide any date by which the ruling request must have been submitted and, if the statute were read literally, it would be possible for taxpayers now to submit ruling requests and come within the exception. This is obviously a typographical error and the Ways and Means Committee Report makes clear that the ruling request must have been submitted by November 20,l985, to qualify for this exception.

The application of these rules has been extensively criticized by the Tax Section in its recent report entitled "Effective Dates of Tax Reform Legislation."[35] That discussion is attached as an appendix to this report and will not be repeated here. In general, the Section concluded that a retroactive effective date is inappropriate and that these provisions should be effective no earlier than a reasonable time after the date of enactment or, perhaps, January 1, 1987. We recognize, and are concerned, that a deferred effective date might lead to an acceleration of acquisition activity in order to avoid the implications of General Utilities repeal, but this consideration would seem to be outweighed by the unfairness of retroactivity.

Moreover, we believe that it is essential that other charges to Subchapter C that are necessary to make General Utilities, repeal work fairly and efficiently (e.g., provisions allowing carryover basis treatment for asset sales) should become effective at the same time.

[35] Tax Notes (March 3, 1986) 863, 866-68.

APPENDIX

3. Illustrative case; repeal of General Utilities doctrine, (a) background.

The foregoing principles may be illustrated by a more extended discussion of the proposal to repeal the General Utilities doctrine. The Bill would repeal the so-called General Utilities rule and would require corporations in a corporate liquidation, with a limited exception for "qualified shareholders" (see below). This required recognition treatment would apply to sales and distributions occurring on or after November 20, 1985 (the date of Ways and Means Committee action), with exceptions for section 338 elections for qualifying stock acquisitions completed before November 20, 1985 and for sales or distributions made pursuant to a plan of liquidation adopted before November 20, 1985.

The repeal of existing Code sections 336(a) and 337(a) formed no part of the "Treasury I" and "Treasury II" tax reform proposals or the Ways and Means Committee's tax reform outline[5] (the so-called "Rostenkowski" plan). Nevertheless, as the Ways and Means Committee neared completion of its work on the Bill, it issued a statement indicating that the Bill would contain such a provision, without however indicating what the effective date would be.[6] Despite prior statements by

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[5] STAFF OF THE JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON WAYS AND MEANS MARKUP (September 26, 1985), reprinted in Bulletin 42 EXTRA, Section 1, Fed. Taxes (P-H) (September 30, 1985).

[6] Ways & Means Compromises on Oil Preferences, 85 Tax Notes Today 229-3 (November 21, 1985) (reporting November 20 Committee action adopting repeal of General Utilities doctrine

Administration and congressional leaders that the provisions of the bill would not have effect before January 1, 1986,[7] the provision was ultimately proposed to be retroactive to November 20, 1985.[8]

(b) transitional rule interpretative problems. In an effort to mitigate the harshness of the proposed early effective date, section 335(b)(1) of the Bill provides that the repeal of existing Code sections 336 and 337 will not apply to a plan of liquidation adopted before November 20. 1985. Section 335(b)(2) and (3) then adds a series of "special rules" intended "to provide relief in situations in which a decision to liquidate has clearly been made."[9] These provisions are an attempt to avoid restricting relief to the class of taxpayers who had adopted formal plans of liquidation prior to November 20, 1985 and, instead, to allow any corporation which had

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in order to make up for revenue loss from oil gas preference compromise).

[7] See, e.g., Packwood, Rostenkowski Issue Statement on Effective Dates of Tax Reform Plans, 85 Tax Notes Today 55-3 (March 18, 1985) ("[I]n general, no changes would be effective before January 1, 1986."); Baker Presents Principles of Fundamental Tax Reform; Pushes Treasury Proposal Effective Dates to Jan. 1, 1986, 85 Tax Notes Today 43-5 (February 28, 1985) (statement by Treasury Secretary that "no administration tax reform proposal will contain an effective date earlier than January 1, 1986.").

[8] The repeal of the General Utilities doctrine was part of the comprehensive overhaul of subchapter C of the Code proposed by the Senate Finance Committee staff. STAFF OF SENATE COMM. ON FINANCE, S. PRT. 47, 99th Cong., 1st Sess., Final Report on Subchapter C (Comm. Print 1985). However, these proposals had not been part of the present reform effort and were publicly released for study only. In any case, the Senate proposals would have been of prospective effect only, applying to transactions pursuant to plans of liquidation adopted after December 31, 1985.

earlier decided to liquidate to be governed by existing law.

The parameters of these novel concepts are not always clear. For example, Bill section 335(b)(2)(A)(ii) applies when "the shareholders or board of directors have approved [a transaction described in Code section 336 or 337]" before November 20, 1985. The Bill does not adequately define "approval" and the legislative history states only that approval will be "deemed" to have occurred if there was, before November 20, 1985, "sufficient written evidence to establish that a decision to liquidate has been approved."[10]

Section 335 (b)(2)(B) of the Bill provides that transactions shall be treated as made pursuant to a plan of liquidation adopted before November 20, 1985 if before that date there had been an offer to purchase a majority of the voting Stock of liquidation corporation or that corporation's board of directions had approved an acquisition or recommended its Approval to its shareholders. However, a non-binding offer that has not been accepted by the target corporation's board of directors will not be qualify. This transition rule applies only if "the [liquidating]) sale or distribution is pursuant to or was contemplated by the terms of the offer or resolution." This rule protects situations where significant steps had been taken toward an acquisition, while limiting that relief to essentially the same

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[9] H.R. Rep. No. 426, 99th Cong., 1st Sess. 288 (1985).

[10] Id. at 288-89.

transaction. The limitation seems undesirable. Once a company has been put up for sale and has received a bid, it should be able to solicit competing bids without such subsequent bids being burdened with tax disadvantages. In any event, the approach taken in the transitional rule invites confusion, which is evident in the accompanying explanation in the report of the Ways and Means Committee. Acquisition proposals do not necessarily address the acquiring company's intention to make a section 338 election or to liquidate the acquired company, and the deemed sales and liquidation pursuant to a section 338 election would generally remain the same despite substantial changes in the acquisition transition. The transitional rule should focus on whether the acquisition, not the liquidating sale or distribution, is pursuant to or contemplated by the terms of the offer or resolution.

(c) imperfection in 10% shareholder exception. Under Code section 336(c), as proposed to be amended by section 331(a) of the Bill, a special rule would be provided to mitigate the effects of the new legislations in which one (or more) individual(s) has owned at least 10% of the stock for a specified minimum period ("qualified stock"). Under this rule, nonrecognition of gain or loss with respect to certain assets would continue to apply to the extent of the "applicable percentage," i.e., the percentage (by value) of the qualified stock of the corporation owned by such 10% individual shareholders on the date of the adoption of the plan of liquidation. The Bill would require this

stock to be owned directly by noncorporate shareholders on the date of adoption of the plan; stock beneficially owned by a 10% individual shareholder through a holding company would, protanto, not qualify for section 336(c) relief. This rule penalizes arrangements which may have been made for sound business reasons; nonresident aliens, for example, often interpose a corporation incorporated in their country of residence in the corporate structure. Moreover a corporation with such corporate shareholders may avoid the rule by rearranging its stock ownership before adoption of the plan of liquidation. During the transitional period before enactment of the Bill, such a rearrangement of stock ownership may be undertaken merely as an insurance policy to take advantage of proposed Code section 336(c), if it is enacted.

However, it is likely that section 336(c) will be modified. In situation where qualifying 10% or greater shareholders own less than 100% of the stock, the relief provided by section 336(c) benefits all shareholders (because the relief is provided at the corporate and not the shareholder level) and not just the 10% or greater shareholders. For example, if qualifying shareholders own 30% of the stock, 30% of the corporate gain would escape tax, but the qualifying shareholders would receive only 30% of the accompanying tax benefits. We understand that Congressional and Treasury staff are aware of this anomaly and will seek to correct it.

(d) recommendations. We would urge a nonretroactive effective date for the repeal of General

Utilities. It is clear that the provisions repealing General Utilities are controversial and are likely to be changed in the Senate. For example, it seems generally agreed that the relief provision applicable if "qualified stock" is outstanding should be amended so that its benefits are better targeted. It seems clearly wrong to enact legislation retroactively when (i) its details are not yet established and (ii) the exemption from tax which is to be repealed has long been recognized and accepted as part of the Code.

Hence, assuming enactment of the Bill in 1986, we would recommend that the repeal become effective on January 1, 1987. It would therefore not apply to liquidating sales or distributions or to elections under section 338 of the Code which took place or were effective as of any date prior to 1987. The date of adoption of a plan of liquidation would not be significant; if a plan was adopted in 1986 but the sale or liquidation distribution took place in 1987 (or thereafter), the repeal provision would apply to such sale or distribution. An alternative rule would extend relief to sales or distributions pursuant to a plan of liquidation adopted in 1986 and to section 338 elections with respect to qualifying stock purchases occurring in 1986, but any such relief should not extend to sales or liquidation distributions made after December 31, 1987

To the extent that there is a special concern regarding the liquidation of publicly-held corporations that continue essentially the same business, management

and equity ownership through a different form of tax entity, such as a publicly-held master limited partnership, a special rule applying an earlier effective date to such liquidations could be crafted.

Finally, we are concerned that if the repeal of General Utilities is applied, in general, retroactively, exceptions will be made for specified transactions by taxpayers who have sympathetic cases, particularly in view of the inadequacies of the Bill's transition rules. To postpone the effective date for certain select taxpayers in this fashion would encourage a skeptical attitude toward the fairness of the tax law and thus defeat one of the principal goals of tax reform.