Taxing Corporate Distributions of Appreciated Property: Repeal of General Utilities Doctrine, Relief Measures and Entity Reclassification Proposals

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One of the most fundamental, yet highly controversial, issues in corporate income taxation involves the recognition of gain or loss to a corporation that distributes appreciated or depreciated property to its shareholders, either during its life or at liquidation. If the corporation, as a separate legal entity for general tax purposes, is allowed to exclude the putative gain on the premise that it has not yet “realized” anything in return for the distribution (the purported holding of the United States Supreme Court in General Utilities), then a significant method for avoiding the normal two-tier tax (one at the corporate level and another at the shareholder level) is created. Though Congress codified the result in General Utilities, mainly in sections 311 and 336 enacted in 1954, since that time it has gradually eroded the doctrine, except as it relates to distributions in complete liquidations of corporations.

Professor Wolfman, discussing the principal recommendations of the American Law Institute, states the case for outright repeal of General Utilities and its statutory progeny. After tracing the history of the doctrine, its procedural infirmities, and examples of abuse
(where some corporations were able to avoid any corporate-level tax during operations), he then describes how several complex Code sections may then be eliminated or simplified. In response to the argument that repeal of the doctrine could have negative effects on our economy, Professor Wolfman asserts that he doubts the empirical data.

Mr. Nolan states the case against repeal of General Utilities where there is a sale or distribution of assets in complete liquidation. He does, however, favor the imposition of a corporate-level tax on “ordinary non-liquidating distributions.”

Among the reasons he opposes repeal in the complete liquidation context are (1) the rate of tax (at both corporate and shareholder levels, assuming two capital gain taxes) would be increased from 20% to 42.4%, on gains which are essentially inflationary in nature; (2) the simplification that could result from such a repeal would have adverse economic effects not justified by a double tax burden; (3) Congress would not tolerate outright repeal of General Utilities and would either exempt capital gain and certain business assets or would adopt a form of shareholder credit for the corporate gains tax; (4) a repeal of section 337 exempting liquidation-period sales from tax at the corporate level would impose a higher tax burden on those who invested in a corporation instead of a partnership; (5) closely held business corporations would be among the biggest losers if repeal took place; (6) with all the capital formation incentives now included in the tax structure, we in fact have only a single-level ordinary tax on corporate earnings, and with the ability of larger corporations to retain earnings, double taxation is not the norm; and (7) the ambiguous nature of goodwill would be subject to corporate-level tax, causing family-type businesses to sell out rather than continue in partnership form.

Finally, Mr. Nolan asserts that the present regime of taxation fosters important social and economic policies that Congress has seen fit to adopt.

It is not surprising to find that the Senate Finance staff proposals to restructure the taxation of corporate entities would also address another long-standing problem — reclassifying ventures which avoid corporate status for tax purposes by operating as partnerships. Partnerships, particularly publicly traded limited partnerships, are quite similar to corporations. Also, since some of these publicly traded partnerships are utilized to syndicate tax shelters to large groups of investors (where losses may be passed through to investors), treating these types of partnerships as corporations seemed a logical extension of the Senate staff proposals.

Mr. Hobbet discusses the reasons given for entity reclassification, including reasons not stated in the staff report, and suggests that
preservation of partnership status for publicly traded partnerships would offer an opportunity to experiment with full integration treatment for entities that might resemble corporations. Integration would mean retaining the "tax-exempt" status of partnership-level income or full pass-through of losses, permitting investors and promoters to elect their tax regime. As Mr. Hobbet concludes, if General Utilities were repealed, taxpayers could choose the partnership as an appropriate full integration system. By limiting the proposal as the staff did, to reclassify only publicly traded partnerships, he observes that tax-shelter-oriented smaller limited partnerships would, in effect, be available to those wealthy enough to invest on their own, an "anti-populist" development.
CORPORATE DISTRIBUTIONS OF APPRECIATED PROPERTY: THE CASE FOR REPEAL OF THE General Utilities Doctrine

BERNARD WOLFMAN*

The outline I have provided has three segments (included as Appendix A). The first is a précis of the history and current state of the so-called General Utilities doctrine. The second is a brief summary of the American Law Institute’s analysis and proposals with respect to that doctrine. The third contains excerpts from the Senate Finance Committee’s proposals on the subject.

Like many of you, I grew up at the bar taking for granted the fact that distributions of appreciated property were exempt from corporate tax. It was just that way! Since no rational response was apparent, one did not ask why. It was the unreasoned Supreme Court opinion by Justice McReynolds that gave the doctrine sufficient dignity to permit it to survive and grow. One came to accept the doctrine as a given. I did not understand it, but I accepted it theologically; like creation, it was there.

I am not sure exactly when it was that I began to question whether the doctrine had to be, but the time did come. At first I kept my doubts to myself. Later, however, emboldened by the piece referred to earlier this morning, Jim Lewis’s 1959 article in the Tax Revision Compendium, I gained the courage to blaspheme. Crisply

and cogently, Lewis’s article argued for the elimination of the central distortion of our corporate tax structure, the *General Utilities* doctrine. It also described several of the possibilities for structural simplification that might result from the doctrine’s repeal.

To begin, let us go back to the doctrine itself and see how it originated. In the early twenties, the Treasury regulations\(^3\) gave it first breath in the context of a corporate liquidation. Without elaboration the regulations announced that no gain or loss would be recognized whenever a corporation distributed assets in liquidation, however they might have appreciated or depreciated. The Treasury gave no reasons for the rule; it simply announced it.

Then, in 1935 the Treasury sought in the *General Utilities* case to tax a corporation on its appreciation in the securities it distributed as a dividend to its shareholders. Promptly upon receipt of the distribution the shareholders sold the securities to a waiting buyer pursuant to arrangements that had been made by the distributing corporation before the dividend had been declared. The Treasury lost before the Supreme Court, producing a doctrine that provides for non-recognition of gain to a distributing corporation upon the distribution of appreciated assets whether or not in liquidation.

I should mention that the argument the Government had advanced successfully in the court of appeals was not addressed by the Supreme Court on its merits, but was ruled out-of-bounds because the Government had not raised it when the case was before the Tax Court. That argument was one the Court came to accept ten years later, on its merits, in the *Court Holding Company* case.\(^4\) That case holds that a corporation is taxable on the appreciation of its distributed assets if its shareholders consummate a sale of those assets in circumstances that would lead a finder-of-fact to conclude the sale had really been made by the corporation. That argument, as I have noted, had been made successfully to the court of appeals in *General Utilities*, but was then rejected by the Supreme Court on procedural grounds.

In the aftermath of the doctrine there was questioning, dialogue and debate, and a great deal of tax planning. Everyone in the tax world knew that when Congress came to review the problems of corporate taxation in 1954, the *General Utilities* doctrine would either be overruled or codified. It was codified, and codification (in sections 311\(^5\) and 336\(^6\)) became a major organizational premise of Subchapter C. It, therefore, became obvious that Congress would have to address the *Court Holding Co.* problem as well in order to relieve

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the arbitrariness of the results of that case. A corporation would be taxed if there was sufficient evidence that the sale by shareholders was pre-arranged and not taxed if the corporation could prove otherwise. Thus, after deciding to codify General Utilities, Congress thought it made sense in that context to enact section 337 to exempt a corporation from tax on its asset gain when realized upon a sale that follows the corporation's adoption of a plan of complete liquidation.

It is an interesting irony that in Justice McReynold's opinion in General Utilities the Court looked to "sale" as the touchstone of realization, justifying non-taxation in that case because no corporate sale had occurred. Yet when doctrine was built around that touchstone, the Congressional response in section 337 was to eliminate the tax even when the corporation sells! One cannot help wondering whether Congress's prime concern should have been codification of General Utilities as it was, or whether it should have been to assure that unrealized appreciation, allowed to accrue untaxed prior to sale, would be taxed to the corporation no later than the time the corporation distributes its appreciated assets to its shareholders. The Congressional decision to codify General Utilities and enact section 337 has permitted a deferral of the corporate tax to turn into an exemption.

As codified in sections 311 and 336, the General Utilities doctrine is applicable not only to distributions of appreciated property that go to shareholders pro rata, as a dividend or in liquidation, but, as the Treasury regulations acknowledged promptly after the 1954 Code was enacted, it is also applicable to distributions in redemption of the distributing corporation's stock. Therefore, corporations could distribute appreciated, marketable securities in order to redeem a shareholder's stock. In the typical redemption case there would be a capital gains tax at the shareholder level with no tax at the corporate level. The shareholder would be free to sell the securities immediately, without further tax.

In 1969 Congress decided quite directly to cut back on the reach of the General Utilities doctrine. But, let us look first at a flanking, indirect slash at the doctrine that had occurred much earlier. In 1950, four years before it codified the doctrine, Congress enacted the first collapsible corporation provision, section 117(m) of the 1939 Code, later to become section 341 of the 1954 Code. Congress did

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so because it had become aware of the fact that corporations were being utilized to produce or purchase assets that appreciated rapidly. Then, before the corporations realized any significant amount of taxable income, they disposed of their assets, by sale or distribution, free of corporate tax. A doctrine called *Kimbell-Diamond*\(^9\) permitted the purchaser of a corporate enterprise to step up the basis of its assets to cost, without corporate tax, whether the purchaser acquired stock from the corporate shareholders or assets directly from their corporation.

Congress found abuse in the situation in which there had been virtually no corporate income tax paid during operations, and yet the corporation was permitted to transfer its assets to a new corporation without tax. The price for this beneficence was only a single capital gains tax at the shareholder level. Perhaps Congress thought the abuse was limited to only a few industries, like the motion picture and real estate industries, and that a collapsible corporation provision would deal with it adequately. In any event, Congress did not focus on the heart of the problem: the ability of a corporation to rid itself of its highly appreciated assets without a corporate tax. Instead, it focused on the shareholder, converting his stock, normally a capital asset, into an ordinary income asset. As a result, since 1950 we have had an extraordinarily dense and complex provision affecting collapsible corporations, one which some tax lawyers have managed to ignore throughout their professional lives. To them it presents no problem. Other lawyers are burdened by it, especially if they have had clients struck by it. Of course, the statute has its relief provisions, section 341(e) for example. Marty Ginsburg understands it, but I am not sure that anyone else does. Strangely enough, however, even Marty may have tired of it. He is willing to give it up in exchange for the repeal of the *General Utilities* doctrine.

The repeal of the doctrine embodied in sections 311 and 336 would justify the repeal of section 341. There are some who say that even after the demise of *General Utilities*, section 341, or something like it, would be necessary to prevent a shareholder's use of a corporation to convert what would have been ordinary income in his hands into a corporate capital gain. They may be right, but I think the conversion possibility is an insufficient reason for keeping the section 341 monster. Two taxes, one at the corporate level and the other at the shareholder level, even though they both may be imposed at only capital gain rates, would seem to me to justify the complete repeal of section 341. If we could rid the law of the *General Utilities* doctrine by repealing sections 311, 336, and 337, we should then also feel

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\(^9\) Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, affirm'd per curiam, 187 F.2d 718 (5th Cir. 1950), cert. denied, 342 U.S. 827 (1951).
comfortable with a simplification of section 338\(^{10}\) that would eliminate all of its consistency requirements.

As I began to say earlier, in 1969 Congress restricted the reach of General Utilities and imposed corporate tax on the appreciation in property which a corporation distributed as stock to effect certain redemptions. The 1982 TEFRA legislation added to the number of redemption situations in which the corporate tax would apply. The statute has grown in both length and complexity because Congress has chosen to deal with so-called abuse cases instead of going to the heart of the problem.\(^{11}\) It has created a maze that only experts can work their way through. It makes busy work for all of us, and it leaves us with a monstrous statute. We have a doctrine that fosters distortion and a law that lacks coherence. It works arbitrarily. Why, then, do we keep the General Utilities doctrine? Will Jack Nolan tell and persuade us?

An important equity issue is embedded in the problem we have been discussing. It seems unfair that if some corporations are to be taxed on their gain, all are not. Today, corporations are taxed if they sell their appreciated assets and continue their corporate life; if they give up their charter, they avoid corporate tax even though the assets will remain in corporate solution at a stepped-up basis, with different shareholders. There is no explanation for taxing those corporations that stay alive and use the proceeds of sale for reinvestment in other productive assets while forgiving the tax on appreciation if the corporation surrenders its charter.

Some would say that our system is essentially one of partial integration, that in important situations we have but one level of tax, not two. Well, let us assume that we are all integrationists, and therefore favor the elimination of the corporate tax. Also, let us assume that we favor partial integration if we cannot have complete integration. Is our present system anything like the partial integration system we would want if we set out to create one? We have opportunities for some corporations some of the time to avoid the corporate tax while others are never able to do so. Can one call that a "system" of partial integration or anything else?

Some people would find it inappropriate to repeal the General

\(^{10}\) I.R.C. § 338 (1982).

Utilities doctrine because it would result in an overall increase in corporate tax revenues. However, if our world were one in which all appreciation were taxed to all corporations and we were thereby going to collect more corporate tax than we wanted, we could share the surplus by reducing the corporate tax across the board. As matters stand now, that potential surplus is distributed, in effect, to those corporations that manage to go through their corporate lives with assets appreciating, and, through the talents of people like us, they avoid paying dividends despite the overhanging threat of the section 531\textsuperscript{12} tax. Then they arrive at that sad day when we are supposed to feel very sorry for them. The corporation is dying! It is liquidating! And these evil people from the ALI want to impose a tax on this dead body, a tax on the appreciation that has accrued during its life.

If you feel sorry for the dead corporation you will not want to repeal General Utilities. As I see it, the decedent corporation is one that managed quite successfully to maneuver through its corporate existence without paying tax on real income that accrued during its ownership of the appreciating assets. It has probably paid no dividends. It has managed, with the kind of help we are all trained so well to provide, to avoid tax under section 531. Is it not time, then, for the corporation to share some of the benefits of the deferral it was permitted to enjoy throughout its life?

We all know that some of the complexity comes not only from the 1969 and later laws dealing with redemptions, but from the recapture provisions as well. Additionally, we have the Bliss Dairy\textsuperscript{13} exceptions. There is old case law like that embodied in Standard Paving\textsuperscript{14} and similar decisions which seem to call for taxation of a decedent corporation. All of that makes for a wonderful course to teach. It creates a scarce resource, producing tax lawyers who are highly specialized and highly rewarded. But is the candle worth the penny? Not as I see it.

The ALI proposals impress me as a simplifying and elegant reform that would bring coherence to a classical, double tax system. Their enactment would do nothing to suggest that we ought not move to integration when and if we want to. However, it would suggest that when we do, we should adopt an integration system. Until we do, we should make the system we have into one that is fair and equitable.

I am not going to play the game of trying to anticipate Jack Nolan's arguments and then answering them before he gets up to make them. I am tempted, but we have been friends too long. I will just

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mention one argument that I have heard, and then I will spend a few minutes on the so-called relief provisions. It has been suggested that there would be a negative effect on our economy if we were to impose a tax on the distribution of appreciated property—that it would somehow create a drag. I do not know what the data are for that proposition or whether there is any empirical basis for it at all.

For purposes of this discussion, I assume that all taxes are likely to take money out of the productive private sector. I would think that if we are looking for a tax system that is relatively non-distortion and relatively neutral, one that in seeking to provide incentives, focuses on them and has a way of checking on whether they succeed, we would work to eliminate the *General Utilities* doctrine. That doctrine distorts economic behavior. Corporations that might otherwise continue are liquidated only for tax reasons and it produces transaction costs that are unnecessary. By taxing all corporate gain by the time a corporation liquidates, if not before, we would reduce the importance of the corporate tax in business decisions.

As a final matter, let us examine the so-called relief provisions that are offered to ameliorate those conditions that repeal of the *General Utilities* doctrine might bring, conditions which some people feel may be too extreme. At the outset, however, let me say that if I had my druthers I would not support any of the relief provisions, and that includes the ALI proposal for a shareholder credit. All I would favor would be sensible transition and phase-in rules. However, I am not persuaded that any permanent exemption is justified.

If I were nevertheless to move in the direction of “relief,” I would be attracted to Jim Lewis’s proposal for the expansion of the section 333 notion of carrying over the basis of the shareholder’s stock, thus deferring his individual tax. What worries me about that, of course, is the prospect of section 1014\(^{15}\) turning the deferral into an exemption.

A second-best option would be ALI-recommended shareholder credit. There are aspects of the credit that could cause a significant and unjustified loss of revenue in favor of a narrow band of shareholders. And I think the proposal is somewhat complex. Nevertheless, given the range of relief provisions that have been talked about, I think that the credit is well worth serious consideration. Like Jim

\(^{15}\) I.R.C. § 1014 (1982).
Lewis's relief proposal, it does nothing to impair the integrity of the corporate tax which complete repeal of the *General Utilities* doctrine would restore.
APPENDIX A
CORPORATE DISTRIBUTIONS OF APPRECIATED PROPERTY: THE CASE FOR REPEAL OF THE GENERAL UTILITIES DOCTRINE

BERNARD WOLFMAN

I. History and Current Law
A. Before the 1954 Code
1. Liquidating distributions: The Treasury Regulations provided that "No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however, they may have appreciated or depreciated in value since their acquisition." Reg. 118, § 39.22(a)-20.
2. Nonliquidating distributions: The Supreme Court rejected the Treasury's effort to treat a dividend-in-kind of appreciated property as a realization by the distributing corporation. General Utilities & Operating Co. v. Helvering (see text page 5). The effect was to have the same rule of nonrealization for dividend distributions of appreciated property as for liquidating distributions.
1. The General Utilities doctrine was codified in section 311(a) to provide that as to nonliquidating distributions, a distributing corporation would not recognize gain or loss on a distribution "with respect to its stock." Section 336(a) provided similarly for distributions in complete or partial liquidations. But there were exceptions.
2. Section 311(a) excepted the distribution of installment obligations from corporate tax immunity, and sections 311(b) and (c) provided exceptions to the general nonrecognition rule in the case of distributions of LIFO inventory and property subject to liabilities in excess of basis. Section 336 had an exception for the distribution of installment obligations.
3. In Reg. section 1.311-1(a) the Treasury conceded that a redemption distribution constituted a "distribution with respect to . . . stock" within the meaning — and protection — of section 311(a).
C. From 1969 to 1982
1. In 1969 Congress added subsection (d)(1) to section 311 to provide that, in general, distributions of appreciated property in redemption of the distributing corporation's stock would result in recognition of the gain to the distributing corporation, except in the following situations for which the immunity of section 311(a) and Reg. section 1.311-1(a) was continued:
   a. a redemption in complete termination of a shareholder's interest (within the meaning of section 302(b)(3)), if he had owned at


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least 10% of the corporation's stock for the twelve-month period ending on the date of the redemption distribution. § 311(d)(2)(A);

b. a distribution of the stock or obligation of a corporation engaged in business, if it had not received a substantial portion of its assets in a section 351 transaction within the five-year period ending on the distribution date and if at least 50% of its stock had been owned by the distributing corporation at any time within the nine-year period ending one year before the distribution. § 311(d)(2)(B);

c. a distribution pursuant to certain antitrust decrees. § 311(d)(2)(C);

d. a distribution to which section 303(a) applied. § 311(d)(2)(D);

e. a distribution to a private foundation. § 311(d)(2)(E);

f. a distribution by a regulated investment company. § 311(d)(2)(F); and

g. a distribution pursuant to the Bank Holding Company Act. § 311(d)(2)(G).

D. After TEFRA

1. Distributions in complete liquidation: Under section 336, appreciated property distributions in complete liquidation remain immune from tax at the corporate level. There are exceptions, however, and gain is recognized:

a. as to a distributed installment obligation unless section 332 covers the liquidation or the obligation was acquired in a section 337 sale. § 453(a), (d)(1), (2);

b. as to "LIFO recapture amount[s]" if the plan of liquidation was adopted after 1981 (section 336(b)) but limited to sums in excess of $1,000,000 if the plan was adopted in 1982 and completed by the end of 1983 (P.L. 97-362, § 101); and

c. as to recapture amounts, as under pre-TEFRA law. See subpart E, infra.

2. Distributions NOT in complete liquidation: If the distributions are not in redemption or partial liquidation, they are exempt, as before TEFRA, under section 311(a), unless they are within one of the exceptions of section 311(b) or (c) or section 453B. Distributions in partial liquidation, however, are no longer protected from corporate tax by section 336, and section 311(d)(1) continues the general rule that, since 1969, has taxed appreciation in redemption distributions. However, section 311(d)(2), as reconstituted by TEFRA, has the following six exceptions to the recognition rule of section 311(d)(1):

a. Distributions from one corporation to another, if the distribution is a dividend so that the distributee takes a carryover basis in the distributed assets under section 301(d)(2). § 311(d)(2)(A).

b. Distributions to a noncorporate shareholder (including an S Corporation), if the distribution is in "partial liquidation," as defined in section 302(b)(4), and is made with respect to "qualified stock," as defined in section 311(e) and section 311(d)(2)(B). The section 302(b)(4) definition is substantially as it was in pre-TEFRA section 346(a)(2). "Qualified stock," a new term, is stock held by a noncorporate shareholder (including an S corporation (section 1371(a)(2)) who held at least 10% in value of the distributing corporation's outstanding stock for
the lesser of the period of the distributing corporation's existence (and that of a predecessor) or the five-year period ending on the date of distribution. The section 318 attribution rules apply liberally, with "family" embracing any individual (and spouse of any individual) described in section 267(c)(4). § 311(e).

c. Distribution of the stock or obligation of a corporation ("controlled corporation"), if
   (i) the distribution is with respect to "qualified stock," as previously defined,
   (ii) substantially all the assets of the controlled corporation consist of the assets of one or more "qualified business[es],"
   (iii) no substantial part of the controlled corporation's "non-business asset[s]" was acquired from the distributing corporation in a section 351 or capital contribution transaction within the five-year period ending on the date of distribution, and
   (iv) more than 50% in value of the stock of the controlled corporation is distributed by the distributing corporation with respect to "qualified stock." (A "qualified business" is any trade or business that was actively conducted for the five-year period ending on the distribution date and was not acquired in a taxable transaction. A "non-business asset" is one not used in the active conduct of a trade or business. §§ 311(d)(2)(C), (e)(2)).

d. The section 303, private foundation, and mutual fund redemption exceptions of pre-TEFRA law. § 311(d)(2)(D), (E), and (F).

3. S Corporations: All gain is recognized on the distribution of appreciated assets by an S corporation. § 1363(d).

E. Recapture — Before and After TEFRA

Notwithstanding otherwise applicable rules of nonrecognition, there have been recapture requirements for the following: depreciation (sections 1245 and 1250), farm losses (section 1251), soil and water conservation and land clearing expenses (section 1252), intangible drilling costs (section 1254), conservation payments (section 617), and investment tax credit (section 47). The recapture rules are not applicable to those complete liquidations and certain other situations in which basis is carried over, and to certain consolidated return cases.

II. The American Law Institute Proposal

A. Proposal C1 — Gain or Loss on Cost-Basis Transfers

1. General Rule — Except as specifically otherwise provided, gain or loss shall be recognized on any corporate transfer of assets, by distribution in kind to shareholders or sale in the course of liquidation.
or otherwise, in which basis does not carry over. In computing gain or loss on any distribution in kind to shareholders, the fair market value of the property distributed shall be considered to be the amount realized.

2. Exceptions and Qualifications — Exceptions to and qualifications of the general rule in paragraph 1 are contained in —
   a. Proposal C2 — Unallocated Premium in Cost-Basis Transfers;
   b. Proposal C3 — Limited Credit to Shareholders for Corporate Tax on liquidating Capital Gains;
   c. Section 1031 — Like-Kind Exchanges;
   d. Section 1033 — Involuntary Conversions;
   e. Section 267 — Losses . . . With Respect to Transactions Between Related Taxpayers;
   f. Etc.

3. Comments:
   a. General Utilities
      The main import of this proposal is to reject the general rule that a corporation does not realize gain by making a distribution to shareholders. The rejected rule is generally attributed to the Supreme Court decision in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), and so it is convenient to think of the proposal as rejecting the General Utilities decision.
      The proposal would generally require recognition of gain in the case of all distributions of appreciated property, whether in liquidation or in redemption of shares or as a dividend, and whether or not in connection with an acquisition by any other party. In addition to requiring recognition of gain on any distribution of appreciated property, the proposal would repeal section 337 in reference to cost-basis sales, since that provision's purpose is to treat sales in the course of complete liquidation like distributions in kind.

B. Proposal C3 — Shareholder Credit for Corporate Tax on Liquidating Capital Gains
   1. General Rule — Any shareholder receiving a liquidating distribution from a corporation shall be allowed a credit against tax for his proportionate share of the corporation's liquidating capital-gain tax.
   2. Limitation — The credit shall not exceed the amount by which the shareholder's tax liability would be reduced if his gain on the liquidation were excluded in computing his income tax.
   3. Definition — “Liquidating capital-gain tax” means the amount by which a corporation's tax liability (and that of any subsidiaries, including any subsidiary disposed of or acquired on a cost basis as provided in Proposal C4) for the year of liquidation and the next preceding taxable year would be reduced by excluding all gains from disposition of capital assets and section 1231 assets, except any such assets (other than goodwill and similar intangibles) whose manufacture, construction, production or purchase was not substantially completed at least five years prior to disposition. The amount excluded under the last sentence shall not exceed, however, the excess of all capital gains and section 1231 gains over capital losses and section 1231 losses for that one of the following periods for which such excess is smallest:
      a. the taxable year of liquidation and the next preceding taxable year;
b. the taxable year of liquidation and the next two preceding taxable years; and

c. the taxable year of liquidation and the next three preceding taxable years.

4. Sale of Shares — Any shareholder who realizes and recognizes a gain on a sale of shares of a corporation which is subsequently completely liquidated within the calendar year of such sale or the next succeeding calendar year, or which is treated as being liquidated under Proposal C4, shall be entitled to a credit against tax for his proportionate share of the corporation's liquidating capital-gain tax, decreased by the excess, if any, of liquidating distributions ultimately made with respect to his shares over the amount realized by him on their sale. Such credit shall not exceed the amount by which such shareholder's tax liability would be reduced if his gain on the sale of his shares were excluded in computing his income tax.

5. Comments

a. Basic Rationale

This proposal responds to the notion that certain gains realized in connection with a corporate liquidation should not be taxed at both corporate and individual investor levels. But it responds by way of a credit for the corporate tax rather than exemption, just as the foreign-tax credit responds to the problem of double taxation of foreign income. Its effect, therefore, is to require that gain on a corporate liquidation be effectively taxed once, either at the corporation's capital-gain rate and by reference to the corporate basis, or at the investor's rate by reference to his basis, whichever produces the higher tax.

In practical terms, this proposal would provide relief from double taxation on a liquidating sale without subjecting the total tax burden to what may be felt to be defects in the individual income tax, particularly as it applies to dispositions of investments in closely held corporations. When a closely held corporation is disposed of, for example, most of the stock may have belonged to a recent decedent. In such a case individual capital gains will have been largely eliminated by the step-up of basis provided in section 1014. Or stock may have been recently conveyed to trusts with low tax rates. Under this proposal, upon a sale or distribution of corporate assets, all gain that has not previously been taxed would be taxed at least at the applicable corporate capital-gain rate. In some cases, of course, that tax could be avoided by selling corporate stock instead of assets, but such a stock sale would not produce a stepped-up basis for corporate assets.

III. Senate Finance Committee Staff Proposals

A. Corporate Treatment of Cost Basis Acquisitions

1. Recognition of gain

Corporations which choose to acquire assets with fair market value
basis would be permitted to do so only through transactions fully taxable at the corporate level. Thus, if the acquiring corporation acquires all of the target corporation's assets for cash, the acquired corporation would be required to recognize all gain on the acquired assets (unless the acquiring corporation and the target corporation expressly elect nonrecognition and a carryover basis). Under present law, there would generally be a step-up in basis without recognition of gain if the target liquidates, except to the extent of recapture, LIFO reserves, and amounts taxed under the tax benefit, assignment of income, or clear reflection of income doctrines.

Similarly, if the acquiring corporation acquires the target corporation through a merger or if the acquiring corporation acquires stock constituting control of the target corporation, the transaction may be done on a cost basis and, in such event, the target corporation would recognize all gain on its assets. The mechanism for making the election and the special rules that apply for cost basis acquisitions of stock have been described above.

Under a cost basis acquisition, the unrealized gain or loss in all of the target corporation's assets would be recognized; the parties could not choose a carryover basis treatment for some T assets and cost basis treatment for other assets. As described above, an exception would be provided for unallocated acquisition premium (i.e., amounts, such as goodwill, that represent the excess of the purchase price over the value of the assets acquired). In addition, nonrecognition and carryover basis treatment could be separately elected for stock in foreign corporations and DISC's.

The recognition rules of section 338 would be conformed to the general rules, as discussed below.

2. Basis of assets and stock acquired

In the case of a cost basis asset acquisition, the assets will take a basis equal to their fair market value. In the case of an acquisition by merger in a cost basis transaction, the assets will also take a fair market value basis. Finally, in the case of an acquisition of stock, both the subsidiary's assets and the stock of the subsidiary will take a fair market value basis. If in any of such cases the acquired corporation and the target corporation elect carryover basis for the purchase premium, then the amount of such premium that is not taxed is excluded from the basis of the assets. Such amount would also be excluded from the basis of the stock acquired, if any.

B. Repeal of General Utilities Doctrine

1. General Rule

Corporations would generally recognize gain on the distribution of appreciated property to shareholders (whether as dividends or in redemption of stock) without regard to the limitations of section 311(d)(2) (including distributions to which section 302(b)(4) applies).

Example IV-40:
X corporation owns appreciated oil reserves with a basis of $100 and a fair market value of $300, together with other assets. X is owned by ten equal shareholders. X distributes the oil reserves to its shareholders as a dividend in kind. Under present law, X would recognize no income to the extent the distribution was covered by earnings and profits, thereafter as a return of capital to the extent of basis, and finally as capital gain to the extent of
any excess. Under the proposal, X would recognize $200 of capital gain on the distribution. Thus, the special rules of section 311(e) enacted in 1982 would be repealed. In the case of distributions to corporations, the basis rule of section 301(d) would continue to apply and no gain would be recognized by the corporation (because the transaction is a carry-over basis transfer).

2. Effective date

The provision generally would apply to distributions made after December 31, 1983, with an exception for distributions made pursuant to a binding contract entered into before thirty days after the date of enactment. If transitional relief were provided, the capital gains tax on historic assets would be phased in over twelve years as under the acquisition and liquidation proposals.

C. Relief From Repeal of General Utilities

In addition to the preceding recommendations, the staff has identified a number of options that ought to be considered if the committee concludes that the outright repeal of the General Utilities rule is too harsh. If the problem is characterized as a transitional problem, then relief could be provided by phasing-in the capital gains tax on liquidations. If, instead, the problem is characterized as a permanent problem, at least five types of options are available. Under the American Law Institute proposals a shareholder credit would be provided for the shareholder’s pro rata share of the capital gains tax paid by the corporation. Second, certain historic assets could be exempted from corporate level tax. Those assets could be all assets which produce capital gain, or the relief could be limited to capital non-depreciable assets. Third, an election could be provided on distributions in kind in liquidation to permit the deferral of one or both of the taxes until the assets were disposed of by the shareholders. Fourth, the corporate capital gains tax rate might be reduced. Fifth, the individual capital gains tax on stock might be reduced. Finally, the committee might conclude that no relief is appropriate. All of these are options that the committee may wish to consider.
I strongly oppose repeal of the General Utilities concept with respect to a sale or distribution of assets in the course of a complete liquidation. As has been suggested, the effect of such repeal would be to revoke sections 336 and 337 and, to the extent that section 338 is part of section 337, much of the practical effect of section 338 and section 334(b)(2) before it. The result of such repeal would be to increase the rate of tax on gains which are essentially investment or inflationary gains. The imposition of this double tax burden would cause a rate increase from 20% to 42.4%. Despite the many perceived simplification gains that could flow from such change, the adverse economic effects of more than doubling the capital gain rate on this element of corporate investment are too great, and the simplification gains are uncertain. The existing effects of sections 336, 337, and 338 in providing for a single tax burden on the distribution or sale of assets upon termination of a corporate business in complete liquidation reflect good tax policy and should not be disturbed.

This is not to say that no changes should be made. The provisions

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of the pending House and Senate bills that would impose a corporate-level tax on *ordinary* non-liquidating distributions of appreciated property are sound. There is no strong tax policy reason to exempt a gain in such cases from the corporate level tax. Non-liquidating corporate distributions are ordinarily made in cash, and if the corporation will continue in existence, the corporate-level gain may appropriately be taxed as if the corporation had sold the property and then made a cash distribution. Indeed, it was for this reason that section 337 was limited to distributions in complete liquidation in the 1954 Code.

The gain with respect to inventory or other property primarily held for sale to customers upon a sale or distribution of those assets in the course of a complete liquidation should also be taxed. Thus, the bulk sale inventory rule in the present section 337 should be repealed. These gains arise from ordinary ongoing business activity of the corporation and should be taxed as ordinary income even in the context of a complete liquidation. To the extent that we do have a two-tiered tax system for corporate income from ordinary business operations where the income is distributed to the shareholders, it properly applies to such income that is distributed in liquidation as well.

Congress acted in 1980 to amend sections 336 and 337 to tax the LIFO reserve in complete liquidations. There is no compelling reason to treat FIFO inventory gains any more favorably. The present bills limit the *General Utilities* concept so that it does not apply to non-liquidating distributions, except in the case of spin-offs or distributions to an 80% or more corporate parent shareholder. The taxation I have suggested of all inventory gains at the corporate level, even in the course of complete liquidations, would achieve significant simplification gains sought by the proponents of repeal of the *General Utilities* concept. Beyond such a framework, however, there might well be no simplification gains. Congress and affected taxpayers will not tolerate the adverse economic effects of repeal of sections 336, 337, and 338 so as to increase the capital gains rate resulting from a complete liquidation from 20% to 42.4%. Congress would either exempt capital assets and section 12316 assets that were held for more than some period of years, such as three years, or would adopt some form of shareholder credit for the corporate capital gains tax. Either step would leave in place many of the complexities and uncertainties of existing law which the opponents of *General Utilities* seek to eliminate.

The acid test of the desirability of repeal may be simply illustrated. A group of investors contribute one million dollars to a corpo-

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ration. They construct a building and operate it for rental income for a long period of years. The value of the building increases to three million dollars because of inflation or general increase in real estate values. The investors decide to sell their investment. If section 337 were repealed they would incur an effective tax burden of 42.4% on the two million dollars of appreciation as opposed to 20% that they would have incurred if they had operated through a partnership or had made a comparable alternative investment. There is no tax policy reason supporting the increase in taxation of the gain derived from corporate investment which did not result from ongoing business activities of the corporation. Actually, if the investors had held the building prior to incorporation and it had appreciated in value at that time, the problem would be exacerbated because the pre-incorporation gain would also be subject to the double tax burden.

This example reflects a widespread problem in the real world that would result from repealing the General Utilities concept. There are a very large number of closely held businesses in the United States holding section 1231 assets which have been used for many years in the corporate business, and have appreciated substantially in value. The real estate involved might be a manufacturing plant or retail store location, rather than a building held for rental. The appreciated assets might instead be patents or some unique collection of personal property which is not readily replaceable and has increased in value, such as a specialized manufacturing facility.

The treatment of goodwill and going concern value by the proponents of repeal is ambiguous. In theory, this gain should also be taxed at the corporate level if other unrealized gains in corporate assets are to be taxed on a sale or distribution in complete liquidation. The Senate Finance Committee Subchapter C staff report proposed, however, that in a so-called cost basis acquisition in which gain would be recognized at the corporate level in a complete liquidation, unallocated acquisition premium or goodwill would not be taxed at the corporate level but would be given a carryover basis. That, however, would not solve the problem as to intangible assets other than goodwill, such as patents and trademarks, and could create new controversies as to what is goodwill. For example, the question would then arise whether know-how, trade secrets, trade names and the like are to be treated in the same manner as patents or trademarks, or as part of some unallocated premium. Furthermore,

the acquiring company might well discount their value for the absence of a stepped-up basis, since they may be sold by it in the future. If that were so, the shareholders of the target company would still bear an implicit tax burden at the corporate level.

Finally, the treatment of such goodwill value in complete liquidations involving distribution of assets in kind is also unclear. If the parties seek to liquidate their corporation, and operate their business as a partnership, the absence of section 336 would cause the value of such assets to be taxed at the corporate level. This could result in the parties being forced to sell their business to others or finding some other way to avoid the double tax burden as to such asset values.

The central argument of the proponents of repeal is that we have a two-tiered tax system in which income is to be taxed both at the corporate level and the shareholder level, and that the General Utilities concept is contrary to that system. In fact, however, we have never had a truly unintegrated corporate tax system in which tax is paid at the corporate level and a second tax is paid on corporate income by the shareholders. Over the seventy or more years that our corporate income tax system has developed, we have had a compromise system in which a double tax has been imposed only on ordinary earnings from regular operations to the extent that they are distributed to the shareholders as dividends. Only a single tax has been imposed upon extraordinary events, such as a sale or distribution of assets pursuant to a complete liquidation. In reality, to a large extent, as Peter Faber suggested earlier this morning, we have had only a single ordinary income tax on regular corporate earnings because of the ability to retain earnings. By reason of our provision for a step-up in basis of assets at death, earnings which had been taxed at ordinary rates at the corporate level have to a large extent been retained and have not been taxed again at the shareholder level. At most they have been subjected to a capital gains tax on sale of the stock at the shareholder level. A large percentage of corporations in the United States, both publicly held and privately held, retain and reinvest in their businesses a large percentage of their annual earnings, partly as a result of the tax advantages to their shareholders that flow from this policy.

This is an entirely healthy system. The top corporate tax rate and the top individual rate are roughly the same. There should be limits on the taxation of income from capital so that capital formation is not inhibited or misdirected away from business investment. Furthermore, to the extent that we provide incentives through tax allowances such as the investment credit, ACRS, the research and development credit, or the intangible drilling cost deduction, there should be no preference for operating in or out of the corporate structure. Virtually all major foreign industrialized countries, includ-
ing the entire European Economic Community and Canada, have moved toward a single integrated tax structure in which only a single income tax is paid on business earnings. Economists tend to favor such a system to avoid undue burdens on capital investment. We have greatly moderated our double tax burden on capital by the types of incentives previously mentioned, and as a practical matter the effect of our present corporate tax structure is that, by a variety of means, we have achieved what is a single tax on the returns from capital. This allows us to remain competitive in the world economy.

There is no important reason at this time to disturb this carefully developed balance that has resulted from seventy or more years of experience in refining our corporate tax system to accomodate the needs of our economy and our society. It is particularly unwise to do so in a way that would impact harshly on privately held smaller companies. The primary consideration affecting our corporate tax structure should be economic efficiency, not simplicity or undue concern with abuse and manipulation that we have been able to control by other means.

It is important to recognize that the impact of repeal of sections 336, 337 and the principal effect of 338 would be largely on closely held family businesses. Large publicly held corporations seldom undergo complete liquidations. The short-term effect would be to bias the decision of these families in favor of merging their family companies into large publicly held corporations in a tax free exchange for stock of those companies, rather than allocating their capital to other uses that might be more efficient. If that were so, the tax law would further interfere with market allocation of capital. In the long run, businesses might tend to avoid incorporation wherever possible. Our capital markets, which are the largest and most efficient in the world, are based on financial instruments of corporations, not those of unincorporated businesses. These markets might adjust, but at a significant cost in the capital formation process. New instruments subject to new dimensions of risk would be required to replace our existing corporate capital instruments.

Many family businesses in the United States hold a wide range of business assets, including real estate from which the business is operated. Mostly as a result of inflation these assets are likely to have appreciated substantially in value over a long period of years. Many family companies have been operated through several family generations, thus greatly increasing the inflationary components of these gains. Even though the family company may have been operated for
many years, the family may have become so large, or the interests of
different family members may have become so diverse, that it may
make greater economic sense for the family to liquidate the corpora-
tion, possibly selling all or a part of its assets or selling their stock,
and then to undertake other business ventures. It may have become
economically more efficient for third parties to acquire the business.
There are a wide range of reasons why it may become appropriate
for the family to terminate its corporate activities by complete
liquidation.

These families have operated on the basis of certain fundamental
assumptions as to our taxing system as it has existed for the last fifty
years, even prior to the time that the *General Utilities* case was de-
cided in 1935. Those assumptions include a clear understanding that
under our tax system, upon a decision to completely liquidate the
business, they could do so and incur only a single capital gains tax
on the appreciation in value of the underlying assets of the business.
This has been the case whether they sell those assets to third parties
or take their respective shares of the assets in kind to operate as sole
proprietorships or as partnerships. In such a case they seek to put
their capital to its most efficient uses in our economy.

A single capital gains tax on this terminal transaction, as if the
gain had arisen from other investment assets held by them, is en-
tirely appropriate. Much of the gain is probably inflationary gain,
and thus it deserves only a single corporate capital gains tax. Even
the balance of the gain which is likely to be attributable to real as-
sets or intangible assets is by its nature essentially an investment
gain and not a gain attributable to a regular business activity that is
typically taxed at higher rates. A tax of 42.4% on this gain is not
justified. The result would be that families wishing to terminate their
family businesses effectively will have one option: to find a publicly
held corporation and take its stock for their company. A publicly
held corporation with tax losses created by ACRS deductions or oth-
wise, or with unuseable investment credits, presumably could elect
to step-up the basis of the assets at the corporate level in a so-called
cost basis acquisition using its own stock at only a minimal tax cost.

It is important to recognize that tax will be paid at the share-
holder level on the appreciation in value of assets held by the corpo-
ration in a complete liquidation except to the extent that the Code
provides explicitly for tax exemption to serve other social or eco-

conomic policies. The shareholders’ gain on liquidation consists of two
elements, retained earnings and appreciation in value of the com-
pany’s underlying assets. The shareholder may, of course, have
bought his shares at a time when such elements already existed to
some degree. If so, his predecessor will have paid tax at the share-
holder level on such elements. Retained earnings and appreciation in
value of corporate assets ultimately always incur a tax at the shareholder level, except to the extent the stepped-up basis at death occurs or the shareholder is tax exempt. Furthermore the recapture rules insure that the ordinary income portion of asset appreciation ultimately is taxed as ordinary income. Retained earnings by definition have already been taxed at the corporate level. What remains is the capital gains portion of the appreciation in value of corporate assets, which ultimately is taxed at the shareholder level except where there has been an intervening death of the shareholder or where the shareholder is a tax-exempt organization or person. Repeal of General Utilities in the case of complete liquidations would tax this appreciation twice, whereas if the business had been operated in noncorporate form this double tax would not have been incurred.

It is incorrect to argue that taxation at the corporate level is necessary to prevent tax avoidance arising from the fact that the shareholder may be a tax-exempt organization, or a foreign person not subject to U.S. tax, or because the gain may be eliminated by a step-up in basis at the death of a shareholder prior to the distribution in complete liquidation. Each of these exemptions from tax presumably serves some economic or social policy that Congress has seen fit to adopt in the Internal Revenue Code. It may well be, of course, that the scope of these exemptions should be reconsidered carefully, but there is no tax policy justification for repealing these exemptions only with respect to gains which arise from corporate investment. The step-up in basis at death, for example, is obviously a major loophole in the tax system, but Congress for whatever reason sees fit to retain it. It cannot properly be partially repealed in a manner that discriminates against corporate investment.

The principal advantages claimed for repeal of General Utilities are the elimination of the substantial complexity and uncertainty that it creates. It is argued, for example, that repeal would permit repeal of the collapsible corporation provisions. It is more likely that Congress would not repeal the General Utilities concept outright, but rather that Congress would ameliorate the effects of any such change either by exempting section 1231 or capital assets held for some period of years or by introducing a shareholder credit for the corporate-level capital gains tax. If either of these steps were taken, it might be necessary to retain the collapsible corporation provisions and many of the other existing complexities and uncertainties that arise out of the General Utilities concept.
Accordingly, we should not repeal *General Utilities* as to sales or distributions of assets in a complete liquidation and impose a double tax burden on asset appreciation existing at that time. An effective tax rate of 42.4% on such gains, as opposed to a 20% rate on other investment gains, would indeed have serious adverse economic effects, particularly on privately held companies. It could create a bias causing owners of family companies contemplating liquidation to merge their companies into publicly held companies in exchange for stock of those companies. In that event, capital would not be directed to its most efficient uses in our economy. We have developed our existing system over a long period of years to respond to the needs of our economy, and we can rectify abuses as was done in TEFRA and in prior revenue acts. There is virtue in stability in our fundamental tax structure.
LIMITED PARTNERSHIPS: ASSOCIATIONS OR PARTNERSHIPS?

RICHARD D. HOBLET*

My subject seems to be a relevant topic in connection with the discussion of *General Utilities* primarily because publicly held limited partnerships, which are a developing form of business, provide a form of integration.

First, it may be useful to all of you to know what some of the non-tax lawyers are saying about publicly held limited partnerships. The American Bar Association in its annual meeting in 1983 had a program on the use of publicly traded limited partnerships presented by the section of Corporations, Banking and Business Law. A brief excerpt from the edited transcript of that program is interesting. The statement was made that

Public partnerships . . . are a part of what one of our panelists . . . has referred to as the devolution of corporate assets into direct ownership. The public partnership vehicle is currently addressing valuation mismatches that have occurred in the corporate world. Those of you who have followed the various takeover battles will be familiar with the results of market under-valuation of business assets. The public partnerships to a great extent deal with the same types of discontinuity that have generated the takeover activity.²

The same theme was developed in an article published in the August 1983 issue of the *Business Lawyer*.³ There the author said this: "The time has come to give serious thought to using the limited

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partnership form for the conduct of widely held businesses. In many cases, it would be highly advantageous for existing corporations to liquidate and thereafter operate as limited partnerships. At about the same time, Forbes magazine reported on what it called "Disincorporating America." That story was prompted by the creation of several so-called master partnerships, the vehicle used for both widely held and publicly traded limited partnerships. The first of these it reported to be The Apache Petroleum Co. and, according to Forbes, this was followed by a spin-off by Masonite corporation of its timberlands and sawmills as a partnership in August 1982, and a spin-off by Newhall Land & Farming of its commercial real estate into a partnership in March 1982. The Forbes article reported that euphoria was reigning among many executives who saw this as a way to avoid the corporate income tax without giving up any of the significant advantages of a corporation.

Soon after the Forbes article appeared, the staff of the Senate Finance Committee reported its recommendations for overhauling Subchapter C. This report had what was a surprise, I'm sure, for some syndicators of tax shelters and those euphoric executives and lawyers who were then actively promoting publicly traded limited partnerships: a recommendation that publicly traded limited partnerships be treated as corporations. The report stated that

[T]he only relevant abuse examined by the staff [in connection with the classification of business entities] has been the recent proliferation of publicly traded limited partnerships. Beginning in 1981, the New York Stock Exchange has listed certain limited partnership interests. As a result, investors are able to invest in large scale tax-exempt business enterprises.

In a footnote to that report, it states that 676 partnerships, each with more than one thousand partners, had gross receipts of nearly six billion dollars and net income of nearly one and a half billion dollars in 1980. The report went on to say: "It is difficult to explain why such large centralized business organizations should be exempt from tax while ordinary corporations are subject to an entity level tax. Thus, the American Law Institute has recommended that limited partnerships with publicly traded interests should not be treated as partnerships."

That was indeed the ALI recommendation, but it was made for a somewhat different reason. The ALI did not base its recommenda-

4. Id. at 1488.
7. SFC REPORT, supra note 6, at 50-51.
8. Id. at 51 n.60.
9. Id. at 51.
tion on fairness so much as it did on the administrative and compliance complexity of dealing with large publicly held limited partnerships.

There was also activity in the House of Representatives on the same basic question in 1983. On October 25, certain members of the Democratic Study Group, who were identified in the Daily Tax Report as "liberal Democrats," published a proposed amendment to HR 4170 that would treat as a corporation any limited partnership having more than a hundred partners. That proposal was rejected by the American Law Institute at the same time that it considered the publicly traded limited partnership. The American Law Institute believed that there should be no limit as to the numbers of partners that could exist in a limited partnership that would be accorded partnership status. Its basic premise was that there really was not sufficient unfairness in the current disparate treatment of limited partnerships and corporations to justify the type of uncertainty that exists today as to the classification of partnerships. They rejected the idea that the numbers of limited partners should have any impact on the classification question.

A good deal of controversy erupted over these two proposals when the Senate Finance Committee and the House Ways and Means Committee held their meetings. The Senate Finance Committee hearings were held in October 1983. The Ways and Means Committee addressed the same subject in February 1984. It was suggested at the mid-winter meeting of the American Bar Association that the recommendation on entity classification had become the most controversial issue in the staff report. After hearing the debate over the repeal of the General Utilities doctrine, whether that is true or not remains to be seen.

Nevertheless, Legal Times reported that major law firms from Chicago, New York, Dallas, San Francisco, Houston, and Washington D.C. had all been retained to represent fifteen companies with a big stake in the entity classification issue. Three principal arguments were advanced by the opponents of the staff's recommendation. The first was that publicly traded limited partnerships are no more like corporations than other limited partnerships and should, therefore, be accorded similar treatment. However, that argument cuts both ways. The fact that two types of transactions or entities are similar, thus deserving similar treatment, does not suggest the direction in
which the law should change. The fact of similarity is entirely neutral on that issue. So, when *Court Holding Co.*\(^{11}\) and *General Utilities* created a conflict for Congress in 1954, Congress could well have decided to repeal the *General Utilities* doctrine and not add section 337\(^{12}\) to the Code. Congress made the other choice. Obviously, if a publicly traded limited partnership is essentially the same as other limited partnerships, it might suggest that all limited partnerships should be treated as corporations.

The opponents' first argument was further developed by saying that Congress should not approach reclassification problems on a case-by-case basis, but that it should do it on a more conceptual level. However, the recommendation of the staff is not necessarily approaching the entity classification issue on a case-by-case basis. It could be interpreted as considering that the type of free transferability present with publicly traded partnerships, with the resulting enhancement in their ability to attract large numbers of investors, as a sufficiently important corporate attribute to cause publicly traded limited partnerships to differ substantively from other limited partnerships, and therefore justify their reclassification as corporations.

The premise of the opponents' argument was that publicly traded units are not a trait intrinsic to corporations and to make the point the opposition cites closely held corporations. In this regard, it is interesting that one of the things that all the discussion and quotation of the *Morrissey*\(^{13}\) case over the years has omitted is the statement that the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise. It also facilitates the introduction of large numbers of participants. Although the staff report made no mention of this, its recommendation could find significant conceptual support in the *Morrissey* case.

The second principal argument against reclassification advanced at these hearings was that the administrative difficulties of taxing limited partnerships having large numbers of partners and many changes in partnership ownership during the year have been overrated. TEFRA made changes in the audit provisions of partnerships which do eliminate some of the problems of administration because the Internal Revenue Service can now audit the partnership and make changes in partnership items that will extend the statute of limitations for the individual partners so that those adjustments can be made on the individual partner's returns. Secondly, the point was made that computers have now made it possible to keep up with the

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various allocations necessary when there are large numbers of changes in partners and large numbers of partners, even to the point of making the appropriate optional adjustments to basis. I think that probably is feasible today.

What the opposition does not emphasize, but what may well be the major administrative problem, is the enormous flood of paperwork that would be generated for the Treasury and the Service if there are a significant number of publicly held limited partnerships with large numbers of partners. A change in a partnership item that is one which the Code and Regulations require to be separately stated may not often result in an easy and standard adjustment to be made to the returns of the individual partners. For example, a change in the interest deduction of a partnership when it flows through will have to be individually treated by each partner in order to determine limitations on investment interest. Likewise, a change in the amount of capital gain or loss or section 1231$^{14}$ gains or losses will result in an individual recomputation for each partner. I foresee millions of individual audits being required to make certain that all those adjustments are made properly at the partner level.

One suggestion that I might make if there is no entity reclassification is that, when there are changes made at the partnership level the individual partners should have an obligation to file a new return. At that point there would again be the imposition of a self-assessment system with each partner being required to make the individualized changes required for such partner's return. Then, the running of the statute of limitations should be suspended until the filing of that return. That would reduce the administrative burdens of the government, but it would materially increase private sector compliance costs.

The third objection that was made to the reclassification of publicly held limited partnerships was not so much an objection to the concept as it was a rebuttal to the thought that the reclassification was necessary to avoid a stampede of corporations being liquidated into partnerships and partnerships being organized instead of corporations. Potential tax liabilities on conversion to partnership form are one substantial impediment. Certainly that would be true if the General Utilities doctrine were to be repealed.

Two significant operational problems were also discussed. One was that there is no perpetual existence for partnerships. I doubt the ac-

accuracy of that premise. Partnership statutes generally state that the certificate has to state a term for the partnership, but they do not generally restrict the length of the term. Could not the term be a thousand years or ten thousand years or even perpetual? Indeed, I believe one of the publicly traded partnerships extant has been said to have perpetual existence.

Another operational problem cited was that the liability of general partners as managers will inhibit the formation of limited partnerships. That is not so clear a problem when you can have a corporation be the general partner under present law. Thus, professional managers can be adequately protected by the use of corporations.

At any rate, notwithstanding the reasons given for the entity reclassification proposal by the staff, there has been the thought that repeal of the General Utilities doctrine might provide a further incentive towards the use of partnerships instead of corporations. Further, with no entity level tax on partnerships, the General Utilities issue has not been an issue in the partnership tax scheme. When there are distributions made to partners there is no tax at the partnership level unless you run afoul of the section 751 collapsible partnership provisions and then that does not impose two taxes because basis adjustments will preserve the single tax scheme.

Since the General Utilities doctrine is an amelioration of the full entity level taxation on corporations, its existence does lessen the advantage that the single tax scheme gives to partnerships. However, there is a question as to how frequently that issue is a factor considered when corporations are organized. It may receive considerable attention by people who are forming collapsible corporations; indeed, it is an elementary principle necessary to consider when forming a collapsible corporation. However, to those people who are forming corporations that are planned to continue and perhaps grow large, that doctrine is one which simply does not appear in the literature as influencing the choice of entity and it is doubtful that it has much, if any, impact on the choice. Nevertheless, the repeal of the General Utilities doctrine has been widely stated as a negative factor in the use of corporations for business entities. Therefore this doctrine may have an impact that is difficult to foresee.

There are probably two principal reasons that have prompted the attempt to reclassify some limited partnerships as corporations. The first and foremost is the general disenchantment with tax shelters. Tax shelters for the masses are available primarily through syndications. As promoters reach out to greater numbers of investors with smaller and smaller amounts to invest, the numbers of SEC registered offerings and presumably publicly traded limited partnerships

can be expected to increase. Taxing them as corporations would certainly inhibit their growth and would effectively limit tax shelters. It would not affect the shelter itself, which would still be available to those who did not need to participate in syndicates to enjoy them. Thus, they would be largely available to individuals with enough wealth to invest on their own, so the proposal really can be seen, ironically, as an anti-populist measure.

Perhaps a more logical solution is that of the American Law Institute which is to deny the deductibility of partnership losses except from operating income from those same partnerships. That does not directly attack the special privileges or incentive provisions in the Code and those would remain viable as tax shelters for individuals who did not have to get involved in partnerships. Therefore, the most rational solution would be to chip away at the special privileges and incentives that exist in the Code without any restriction on the use of those provisions by partnerships, making those tax shelters remain available to many people instead of just a few.

The second principal reason that has been given for promoting entity reclassification is the reason given by the staff of the Senate Finance Committee: fairness. That, of course, involves the question of whether or not limited partnerships that are publicly traded so resemble corporations that they should be taxed in the same way. In defense of the repeal of the General Utilities doctrine it was said that if some corporations must pay a tax on their gains, all should. I certainly agree with that, but the problem of determining what is a corporation is also a necessary question to address in achieving fairness among entities. The recommendation by the Senate Committee staff can be seen to be a judgment on the same resemblance test that we find in Morrissey, and that has been posed by Congress for the Treasury and taxpayers from the beginnings of federal income tax. Ever since the 1894 Revenue Act it is quite clear that the Congress has intended to make a distinction between corporations and partnerships. Corporations, joint-stock companies and associations have been treated one way, and partnerships have been singled out for different treatment. However, the courts have been assigned the task of distinguishing between them.

In following that mandate, the Supreme Court could not have done much differently than it did in the Morrissey case, that is, to establish a resemblance test of some sort. However, in stating the issue as to whether the entity bore sufficient resemblance to a corporation, the Court gave a narrower meaning to “corporation” than it
might have. Had it formulated the issue as one of resemblance between the entity and any of the various associations and joint-stock companies that were clearly intended to be taxed, it might have broadened the definition sufficiently to draw limited partnerships into the corporation category. Had that comparison been drawn, the absence of mutual agency as between the general partners and the limited partners might have been regarded as an important factor. The ability to hold title in the organization’s name, and sue and be sued in one’s own name were stated in the *Morrissey* case as factors, and they may have been regarded at an earlier time as important factors. Whether or not the entity was a creature of statute could very well have been regarded as an important issue. *Morrissey*, with respect to corporations and trusts, implied that this was an important attribute. Corporations were creatures of statute. What *Morrissey* said was that, after *Hecht v. Malley*, this attribute was not a necessary one for finding the entity to be a corporation.

Limited partnerships, of course, have considerable similarities to corporations in being creatures of statute. The filing of a certificate of limited partnership is a precondition to the limited liability of limited partners. Likewise, the filing of a certificate of incorporation is necessary for the existence of the corporation and, therefore, the limited liability of its shareholders. Partnership acts prescribe limits on the names that can be used and grants limited liability to limited partners.

As to limited partnerships, the Revised Limited Partnership Act is moving partnerships closer to corporations than did the Uniform Act. I believe that the Revised Act implies that partners have an option of granting limited liability to the general partners. I have seen at least one such agreement, drawn in Minnesota under the Minnesota Act, that purports to eliminate personal liability for the general partners. It is my understanding that this new provision is the reason for the amendment the Treasury made to the regulations saying that there must always be at least one general partner with unlimited liability.

In 1918, the Ninth Circuit Court of Appeals, in *Haiku Sugar Co.*, did question whether the legal effect of the partnership in that case was to create a joint-stock company rather than a partnership. I have found no other case where the resemblance test has been stated to be between the organization and something other than a corporation. *Haiku Sugar Co.* found two significant differences between a partnership and a joint-stock company. Unlike shareholders of joint-stock companies, the members of a partnership could not freely

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17. *Haiku Sugar Co.* v. *Johnstone*, 249 F. 103 (9th Cir. 1918).
transfer their shares. Second, management by partners differs from the board of managers’ representative management of joint-stock companies. The court also noted that the partnership in question had relatively few partners drawn to each other by feelings of mutual confidence and was therefore unlike joint-stock companies which were said to consist of large numbers of persons among whom there is no special relationship of confidence. *Haiku Sugar Co.* suggests the possible result of adopting that test is that limited partnerships would be taxed as corporations today; certainly it would have treated publicly traded limited partnerships as corporations.

In closing, I might suggest a different reason to preserve partnership status for publicly traded limited partnerships, the reason having to do with full integration of the corporate and individual tax systems. The United States has some experience with a fully integrated corporate tax system, but that experience is limited. In the 1964 Act there was full integration for a catch-all group of corporations. Today there is full integration for some controlled foreign corporations and S corporations. Preservation of partnership status for publicly traded limited partnerships provides full integration for entities that resemble corporations and other associations. If that creates a trend towards the election of full integration treatment for entities that might normally have been taxed as corporations, it might provide the means to experiment with full integration before going all the way or rejecting it as impractical. That might be the most sensible way of easing into full integration. In the meantime, the *General Utilities* doctrine could be repealed and those who would choose full integration as the appropriate solution could opt for that by using a publicly traded limited partnership for business entities.