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The Type D Reorganization After 1986: A Case for Repeal

*Kelley Walsh White**

I. INTRODUCTION

A. Three Different Types of Distributions

A shareholder generally is required to include part or all of the value received from a corporation in gross income. The tax consequences of a corporate distribution vary depending upon the distribution's classification. This Article will discuss three types of distributions.

The first type of distribution is one from an on-going corporation with respect to a shareholder's stock.¹ This kind is generally treated as a dividend to the extent of the corporation's earnings and profits.² The full amount of the dividend is included in the shareholder's gross income and is taxed as ordinary income.³ This type of distribution will be referred to throughout this Article as a "normal dividend distribution."

Another type of distribution is one that is made as a payment in exchange for the shareholder's stock. This distribution occurs in liquidation transactions⁴ and in certain redemption transactions that involve meaningful reductions in the relative ownership interests of the shareholders.⁵ This type of distribution is included in the shareholder's gross income, but the amount of income recog-

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1. See I.R.C. § 301. Unless otherwise indicated, references to sections are to the Internal Revenue Code of 1986 as amended [hereinafter the Code].

2. I.R.C. § 316(a).

3. See I.R.C. § 301(c)(1). If the distribution amount exceeds the amount of the corporation's earnings and profits, the remaining amount is first applied against the shareholder's stock basis, and any amount in excess of the stock basis is treated as a gain from the sale or exchange of property. I.R.C. § 301(c)(2)-(3).

4. See I.R.C. § 331(a). Section 331(a) provides that "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." I.R.C. § 331(a).

5. See I.R.C. §§ 302(b), 317(b). Under section 317(b), stock is treated as redeemed by a corporation "if the corporation acquires its stock from a shareholder in exchange for

nized is limited to the gain realized in the exchange transaction.⁶ Any resulting gain is characterized as a capital gain rather than as ordinary income.⁷ This type of distribution will be referred to throughout this Article as an "exchange distribution."

A third type of distribution is a distribution of cash or other property that is made in connection with a corporate reorganization.⁸ This type of distribution will be referred to throughout this Article as a "boot distribution."⁹ The tax treatment of a boot distribution is much like that of an exchange distribution because the amount of income recognized is limited by the shareholder's amount of realized gain (hereinafter referred to as a "dividend within gain limitation").¹⁰ The difference between the boot distri-

property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b).

6. I.R.C. §§ 302(a), 331(a).

7. See I.R.C. §§ 331(a), 1012 and 1221(a). The Tax Reform Act of 1986 essentially eliminated the preferential treatment of capital gains by rewriting section 1202. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 205 (1986) [hereinafter 1986 Act]. Prior to 1986, section 1202 allowed individuals to deduct 60% of net capital gains from gross income. Because the maximum tax rate at the time was 50%, the deduction meant that net capital gain was taxed at a maximum rate of 20% (i.e. 40% x 50%). Today, the characterization of income as capital gain is still relevant but only when the taxpayer uses a capital loss to offset the capital gain. See I.R.C. § 1211(a). Thus, if a shareholder has significant capital losses, classifying the distribution as a liquidation or as a redemption involving a significant reduction in interest allows the taxpayer to offset those losses against the capital gain realized in the distribution. For further discussion of the 1986 Act, see *infra* notes 94-131 and accompanying text.

8. The corporate reorganization provisions, set forth in section 368, define certain transactions that may fall within the corresponding nonrecognition rules of sections 354, 355 and 361. There are six different types of these transactions defined in the Code; all include stock as the consideration used in the transactions. See I.R.C. § 368(a)(1)(A)-(G). A reorganization may take the following forms: a statutory merger (§ 368(a)(1)(A)); a stock purchase (§ 368(a)(1)(B)); an asset acquisition (§ 368(a)(1)(C) or (D)); a divisive transaction (§ 368(a)(1)(D)); a recapitalization (§ 368(a)(1)(E)); or a "mere change in identity, form or place of one corporation" (§ 368(a)(1)(F)). These transactions are commonly referred to by their subsection designations ((A)-(G)). Cash and/or other property may be included as part of the consideration used in all of these transactions except the type (B) reorganization (§ 368(a)(1)(B)), but the cash and/or other property that is distributed is treated as "boot." See I.R.C. § 356(a). In the reorganizations that permit boot to be used as part of the consideration, the boot is subject in part to taxation under section 356. See *infra* note 10.

9. I.R.C. § 356. "Boot" consists of additional consideration in the form of a cash payment or other property that accompanies an exchange or transaction.

10. I.R.C. § 356(a)(1). Section 356(a) provides that

[i]f section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

bution and the exchange distribution, however, is that the income received in a boot distribution usually is taxed as ordinary income like the normal dividend distribution. The income received in the exchange distribution is treated as a capital gain.¹¹ This type of distribution will be referred to throughout this Article as a "boot distribution."

B. The Liquidation/Reincorporation Transaction

The amount of income included in a shareholder's gross income and the characterization of that income will vary depending on how a particular distribution is classified. Before the enactment of the Tax Reform Act of 1986, major disputes arose when shareholders attempted to structure transactions involving a distribution of a corporation's assets (usually a liquidation) as exchange transactions in order to take advantage of the preferential tax treatment afforded to exchange distributions. The shareholders would keep only the liquid assets and would reincorporate the operating assets to continue the operation of the business.¹² This transaction is referred to herein as a "liquidation/reincorporation" transaction.

Substantively, the distributions appeared to be normal dividend distributions. Essentially, the shareholders extracted the earnings

Id. at § 356(a). This section, which provides a dividend within gain limitation, operates to limit the amount of income recognized in the same way section 336(a) limits the amount of income recognized in liquidating distributions. *Id.* See *infra* note 25 and accompanying text.

11. Section 356(a)(2) governs the characterization of the income in a boot distribution. I.R.C. § 356(a)(2). This section characterizes the income as ordinary income if the distribution has the effect of a dividend and the corporation that made the distribution has sufficient earnings and profits to cover the amount of the dividend. *Id.* The section 302 redemption rules are used to determine whether the distribution has the effect of a dividend. Section 302 generally requires a reduction in a shareholder's proprietary interest before permitting exchange treatment. *Id.* at § 302(b). Dividend equivalence is not automatic, but generally it will apply in a transaction designed as a liquidation followed by a reincorporation. In those cases, there probably will be no change in the shareholder's proprietary interest. See *infra* notes 58-60 and accompanying text. If the distribution does not have the effect of a dividend, however, it will be characterized as a capital gain like the liquidating distribution. I.R.C. § 356(a)(2). In the Supreme Court's most recent pronouncement on section 356, the Court held that the effect of the exchange as a whole must be examined in order to determine whether an exchange has the effect of a dividend distribution under section 356(a)(2). *Commissioner v. Clark*, 109 S. Ct. 1455, 1462 (1989). The Court further concluded that the redemption tests of section 302 should be applied after the reorganization has occurred because this approach acknowledges that there would have been no cash payment absent the exchange. By accepting the cash payment, the taxpayer experienced a meaningful reduction in potential ownership interest. *Id.*

12. For a discussion of the different forms of the liquidation/reincorporation transaction, see *infra* notes 39-48 and accompanying text.

out of the business, which enabled them to avoid the dividend distribution rules and continue the business of the corporation as before. When challenged, shareholders argued that, because these transactions qualified formally as exchanges, the distributions should be treated like exchange distributions.

By treating distributions as exchange distributions, rather than as dividend distributions, the shareholder's stock basis could offset the amount of income. A dividend distribution could not receive similar treatment.¹³ In addition, the exchange distribution qualified for the capital gain deduction although the dividend distribution did not.¹⁴ The final benefit provided by the exchange distribution was at the corporate level. The reincorporated assets received a stepped-up basis.¹⁵ Along with this basis came the potential to generate additional tax savings from future depreciation deductions.¹⁶

The government perceived this liquidation/reincorporation transaction as an abusive tax avoidance method and attempted to combat the abuses associated with the transaction.¹⁷ Because the appearance of the transaction closely resembled a dividend distribution, the government could have logically argued that the distributions were subject to the normal dividend distribution rules of section 301.¹⁸ In some cases, the government attempted to use this

13. See *supra* notes 4-6 and accompanying text.

14. See *supra* note 7 and accompanying text.

15. Section 362(b) provides in part: "If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." I.R.C. § 362 (b).

16. See I.R.C. § 167(a). This result was extremely beneficial prior to 1986 because the step-up in the basis of the corporate assets was allowed even though no corporate level tax was imposed on the liquidation of the assets. See I.R.C. § 336 (1954). See also *infra* note 44 and accompanying text.

17. This topic has been discussed by several different commentators. See generally, Krasner, *Liquidation/Reincorporation After the Tax Reform Act of 1986*, 24 WILLAMETTE L. REV. 885 (1988); Mentz, *Reincorporation—At Long Last a Legislative Response*, 43rd N.Y.U. INST. ON FED. TAX pt. 1, § 4 (1985); Nunnallee, *The "Liquidation-Reincorporation" Doctrine Revisited After The Tax Reform Act of 1984: Do Sections 302 and 304 Provide The Solution?*, 40 TAX LAWYER 1 (1986); Westin, *In Like A Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse*, 42 TAX NOTES 997 (1989).

18. See *supra* notes 1-3 and accompanying text. Because the corporation never really ceases operations in these types of transactions, the government could have argued that, in substance, a liquidation never occurred. In fact, the legislative history indicates that section 331 is an exception to the normal dividend distribution rules of section 301 and that it is intended only to apply in situations when a business has been partially or completely liquidated. See S. REP. NO. 39, 68th Cong., 1st Sess. 11-12 (1924); See also Westin, *supra* note 17, at 1007.

exact argument.¹⁹ Perhaps because the language in the liquidation provision states expressly that normal dividend rules are not applicable to liquidation transactions,²⁰ the courts did not widely accept the government's argument. Rather, courts took the position that the distributions in the liquidation/reincorporation transaction had to be taxed outside the normal dividend rules even though, substantively, the distributions looked more like normal dividend distributions than exchange distributions.²¹ The government, therefore, resorted to an alternative argument to attack the liquidation/reincorporation transactions.²²

C. *Treatment as a Reorganization*

The government argued that the liquidation/reincorporation transaction constituted a corporate reorganization.²³ This approach allowed the government to characterize the income received in the distribution as ordinary income rather than as capital

19. See *Breech v. United States*, 439 F.2d 409, 411 (9th Cir. 1971); *Davant v. Commissioner*, 366 F.2d 874, 889-90 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967) (applying § 301 to the distribution after finding that the distribution was unrelated to the transaction); *Estate of Lammerts*, 54 T.C. 420, 439 (1970); *Gallagher v. Commissioner*, 39 T.C. 144, 163 (1962) (court held that the transaction could only be analyzed under the reorganization provisions, rejecting the government's argument that no liquidation took place), *acq. in result* 1964-2 C.B. 5. See also Rev. Rul. 61-156, 1961-2 C.B. 62 (applying Treas. Reg. § 1.331-1(c) and § 1.301-1(1) and finding the distribution taxable as a dividend under § 301).

20. See I.R.C. § 331(b). Section 331(b) provides that "[s]ection 301 . . . shall not apply to any distribution of property . . . in complete liquidation." I.R.C. § 331(b).

21. See *supra* text accompanying notes 1-3.

22. The only rules from subchapter C that could apply were the liquidation rules in section 331, the redemption rules in section 302 or the reorganization rules in section 368. For some unknown reason, the courts more willingly accepted the application of the reorganization rules than the liquidation or redemption rules. The government did attempt to apply the redemption rules in at least one case, but a closely divided court rejected this argument. See *Gallagher v. Commissioner*, 39 T.C. 144, 163 (1962). The courts' strict adherence to the language in sections 301 and 302 and consequent refusal to recast the liquidation/reincorporation as a dividend or redemption is inexplicable. With regard to the reorganization definitions, courts have refused to give equally specific language a literal interpretation. See *Hjorth, Liquidations and Reincorporations-Before and After Davant*, 42 WASH. L. REV. 737, 740 (1967) (discussing how courts willingly applied the reorganization definitions even in situations in which the transactions involved did not literally conform to the definitions, while refusing to apply section 301 unless there was literal compliance with the language in the statute).

23. *Liddon v. Commissioner*, 230 F.2d 304, 309 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52, 58 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Lewis v. Commissioner*, 176 F.2d 646, 650 (1st Cir. 1949); *Survaunt v. Commissioner*, 162 F.2d 753, 758-59 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945); *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 309-10 (1964).

gain.²⁴ The amount of income subject to tax, however, remained the same as in an exchange distribution because section 356(a) contains a "dividend within gain limitation" that limits the amount of income recognized by the shareholders to the amount of gain realized in the distribution transaction.²⁵ This approach at least allowed the government to win the characterization battle, although the shareholder was able to avoid including the full amount of the distribution in gross income. Because the reorganization provisions allowed the government to attack the characterization of the income in the distribution, the government gained some leverage to combat the liquidation/reincorporation device.

The most successful government argument was based on the type (D) reorganization.²⁶ Although many of the courts accepted this argument,²⁷ there were significant problems associated with using this type of a provision to alleviate the abuses associated with the liquidation/reincorporation transaction. The problems arose because the reorganization provisions were never intended to be used as a weapon against taxpayers.²⁸ As a result, the analysis did

24. All distributions are classified as boot distributions subject to tax under section 356.

25. See I.R.C. § 356(a)(1). Section 356 in the 1954 Code and its predecessor section 112(c) in the 1939 Code contained the dividend within gain limitation that exists today under section 356.

26. See I.R.C. § 368(a)(1)(D). Section 368(a)(1)(D) defines a (D) reorganization as a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders . . . or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

I.R.C. § 368(a)(1)(D).

The government also used the type (E) and (F) reorganization provisions in this context. Section 368(a)(1)(E) defines the type (E) reorganization as a "recapitalization." *Id.* at § 368(a)(1)(E). The government used this provision in Revenue Ruling 61-156, 1961-2 C.B. 62, but no case law supports this argument, and no court has ever accepted using the type (E) provision in the liquidation/reincorporation context. See Mentz, *supra* note 17, at § 4. Section 368(a)(1)(F) defines the type (F) reorganization as "a mere change in identity, form or place of organization of one corporation, however effected." I.R.C. § 368(a)(1)(F). This provision was more widely accepted by the courts, but The Tax Equity and Fiscal Responsibility Tax Act of 1982 amended the definition of the type (F) reorganization so that it applies only to transactions involving one entity. Thus, the type (F) provision can no longer be used because the liquidation/reincorporation transaction involves two corporations. See Westin, *supra* note 17, at 1000.

27. See Hjorth, *supra* note 22, at 745; see also Nicholson, 335-2nd T.M. *Liquidation-Reincorporation* (1989).

28. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924); S. REP. NO. 398, 68th Cong., 1st Sess. 14-15 (1924) (discussion indicated that the purpose behind the reorganization provisions was to provide relief to taxpayers in transactions where no economic gain was actually realized).

not adequately address all of the abuses involved in the liquidation/reincorporation transaction. Specifically, the reorganization provisions did not provide for the more sensible result; that is, inclusion of the full amount of the liquid assets retained by the shareholders in their gross income.

Not until the Tax Reform Act of 1986 was there finally an impact on the abuses associated with the liquidation/reincorporation transaction.²⁹ Two changes, the repeal of the capital gains deduction³⁰ and the repeal of the *General Utilities* doctrine,³¹ significantly reduced the potential for abuse in the liquidation/reincorporation context. In certain limited circumstances, the liquidation/reincorporation transaction can still be used as a means to withdraw liquid assets and to avoid the normal dividend distribution rules of section 301.³² The abuses that remain today, however, will no longer be attacked under the (D) reorganization provision. Treatment under section (D) yields the same or even better tax results for the taxpayer in most of the instances in which the liquidation/reincorporation transaction can still be used to circumvent the normal dividend rules.³³

This Article discusses how the 1986 Act's changes affected the abuses associated with the liquidation/reincorporation transaction and how these changes reduced the continued usefulness of the (D) reorganization provision as a weapon against the abuses that remain. Part II outlines the specific steps and goals associated with the liquidation/reincorporation transaction,³⁴ and Part III discusses the historical problems associated with utilizing the (D) reorganization provision as a weapon against this type of transaction.³⁵

Part IV argues that the 1986 Act no longer allows the (D) reorganization provision to function as an effective weapon against the remaining problems associated with the liquidation/reincorporation transaction.³⁶ The focus of Part V is that the (D) reorganization provision is no longer necessary to reach the transaction it

29. See *infra* notes 94-131 and accompanying text.

30. See *infra* notes 100-04 and accompanying text.

31. See *infra* notes 105-07 and accompanying text. Neither the repeal of the capital gains deduction nor the repeal of *General Utilities* doctrine were aimed specifically at the liquidation/reincorporation transaction. For a description of the *General Utilities* doctrine, see *infra* note 41.

32. See *infra* notes 108-31.

33. *Id.*

34. See *infra* notes 38-48 and accompanying text.

35. See *infra* notes 49-93 and accompanying text.

36. See *infra* notes 94-131 and accompanying text.

originally was intended to reach and now exists only as a provision to be used by the taxpayer for tax avoidance purposes.³⁷ Based upon this analysis, this Article proposes that the (D) reorganization provision should be repealed.

II. STRUCTURES AND TAX CONSEQUENCES OF THE LIQUIDATION/REINCORPORATION TRANSACTION

The liquidation/reincorporation transaction structures vary in order to avoid treatment of the transaction as a normal dividend distribution or as a boot dividend distribution. This section of the Article describes the transaction's two most common forms.³⁸

A. A Liquidation Followed by a Reincorporation

Before 1986, two types of liquidation/reincorporation transactions allowed shareholders to extract the earnings from a corporation without being subject to the dividend distribution rules.³⁹ In the first form, one corporation completely liquidated and distributed all of its assets, including its operating assets, to its shareholders. The shareholders realized a capital gain on this distribution measured by the difference between the fair market value of the assets distributed and the adjusted basis in their stock.⁴⁰ Although a tax was imposed on the shareholder level gain, historically the corporate level gain was afforded non-recognition treatment.⁴¹

Following the liquidation, the shareholders transferred the operating assets into a newly formed corporation controlled by them. This reincorporation transaction did not increase the tax burden of the overall transaction because any gain realized by the shareholders in the reincorporation transaction was not recognized.⁴² The newly formed corporation received similar non-recognition treat-

37. See *infra* notes 132-49 and accompanying text.

38. See generally Hjorth, *supra* note 22; Mentz, *supra* note 17.

39. For a discussion of the dividend distribution rules, see *supra* text accompanying notes 1-3.

40. I.R.C. § 331(a).

41. See I.R.C. § 336(a) (1954). The nonrecognition rule for corporate level gain after a distribution of appreciated property, commonly known as the *General Utilities* doctrine, was based on *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). This rule was applied statutorily to liquidating and non-liquidating distributions prior to 1987. See I.R.C. §§ 336(a), 311(b) (1954). Today section 336(a) imposes a corporate level tax on the corporate gain realized in a liquidation transaction. The gain is measured by the difference between the fair market value of the assets distributed and the corporation's adjusted basis in the assets. I.R.C. § 336(a). For a further discussion of the *General Utilities* doctrine, see *infra* notes 105-07 and accompanying text.

42. See I.R.C. § 351(a). Section 351(a) permits nonrecognition of gain "if property is transferred to a corporation by one or more persons solely in exchange for stock or secur-

ment on the reincorporation of the assets.⁴³

Overall, the transactions enabled the shareholders to continue the operation of their business in the form of a newly created corporation and to extract the liquid assets from the business at a capital gain cost. In addition, the corporate assets received a free step-up in basis because no corporate level tax was imposed in the liquidation transaction.⁴⁴ The extra basis in the corporate assets could then be used in the future to generate additional depreciation deductions.

By contrast, if the operating assets were left in corporate solution and the corporation simply distributed the liquid assets as a normal dividend distribution to the shareholders, the full amount of the distribution would be included in the shareholders' gross income and would be taxed as ordinary income rather than as a capital gain.⁴⁵ The assets not distributed to the shareholders would not receive a step-up in basis.

B. A Sale of Assets Followed by a Liquidation

The second form of the liquidation/reincorporation transaction was similar in effect to the first, but it reversed the steps of the transaction. In this form, the first corporation would sell its operating assets to another corporation controlled by the same shareholders. Following this sale, the transferor corporation would distribute the proceeds from the sale, along with the other liquid assets retained, to the shareholders of the first corporation under a plan of complete liquidation.

This second scenario produced the same favorable tax treatment for the shareholders. Only the capital gain realized by the shareholders in the liquidation transaction was taxed.⁴⁶ The corporate level gain realized from the sale of assets received nonrecognition treatment under old section 337 because a complete liquidation of

ities in such corporation and immediately after the exchange such person or persons are in control" I.R.C. § 351(a).

43. See I.R.C. § 1032(a). Section 1032(a) permits nonrecognition to a corporation "on the receipt of money or other property in exchange for stock . . . of such corporation." I.R.C. § 1032(a).

44. See I.R.C. § 362(a)(1). The liquidation itself created no corporate level tax. The recapture rules in sections 1245 and 1250, however, had the potential to trigger some tax consequences for depreciation recapture. The shareholders received a step-up in the basis of the assets because they recognized gain in the liquidation transaction. See I.R.C. § 334(a). Upon reincorporation, the corporation took a transferred basis in the assets. I.R.C. § 362(a).

45. See *supra* text accompanying notes 1-3.

46. I.R.C. § 331(a).

the transferor corporation followed it.⁴⁷

Again, the overall effect of this transaction allowed shareholders of the transferor corporation to continue their business in the form of a new corporation and, at the same time, to withdraw the accumulated earnings and profits of the business. They paid only a shareholder level tax at a preferential capital gain rate. In addition, the corporate assets also received a free step-up in basis even though no corporate level tax was imposed on the sale of the assets.⁴⁸ Further depreciation deductions then could flow from the increased basis in the assets to generate additional tax savings in the future.

III. CLASSIFICATION AS A (D) REORGANIZATION

A. Background

The liquidation/reincorporation transaction began to evolve as early as the 1940s.⁴⁹ Nevertheless, the law in effect at the time did not contain provisions to deal with the liquidation/reincorporation transaction. Consequently, the government was forced to begin combatting these abusive transactions by resorting to other provisions in the Code.⁵⁰ The argument based on the reorganization provisions, the (D) reorganization provision in particular, proved most successful.⁵¹ The government still uses this argument today because Congress has never enacted a provision to deal specifically with the liquidation/reincorporation transaction.⁵² The reorgani-

47. I.R.C. § 337(a) (1954). Section 337(a) provided:

If within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

Id.

48. See I.R.C. § 1012.

49. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 14.54 (5th ed. 1987). See also Bakst, *Does Dissolution Followed by Reincorporation Constitute a Reorganization?*, 33 *TAXES* 815 (1955).

50. See *supra* note 22.

51. See *supra* notes 26-27 and accompanying text.

52. In 1954 the House proposed a Code section to deal with the liquidation/reincorporation abuses, but it was only designed to deal with the situation in which a liquidating corporation transfers assets to its shareholders who in turn transfer the assets to a controlled corporation. The section did not address any other forms of the transaction. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 38 (1954). It was later dropped in conference with the statement: "It is the belief . . . that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision," and these questions "can appropriately be disposed of by judicial decision or by regulation within the framework . . . of the bill." See CONF. REP. NO. 2543, 83d Cong.,

zation provisions include rules that allow both corporations⁵³ and shareholders⁵⁴ to avoid immediate taxation in certain specifically defined acquisitive and divisive transactions.⁵⁵ The shareholders generally receive nonrecognition treatment, however, only when they receive stock.⁵⁶ If they receive other property or cash, as well as stock in a reorganization transaction, then the non-stock consideration is generally treated as a boot distribution and is taxable to the extent of the gain realized in the exchange transaction.⁵⁷

The redemption rules of section 302 now determine the characterization of the boot distribution.⁵⁸ When the reorganization provisions were first used to attack liquidation/reincorporation transactions, an automatic dividend rule was in effect, and boot distributions of cash or other property automatically were charac-

2d Sess. 41 (1954). Since that time, no other independent provisions have been enacted. The one change made by the 1954 Code that affected the liquidation/reincorporation transaction was the addition of section 354(b). This section required that substantially all of the transferor's assets be transferred in the liquidation/reincorporation transaction for it to qualify as a non-divisive (D) reorganization. See I.R.C. § 354(b). Essentially, section 354(b) took divisive transactions out of the scope of section 354. This change actually was made to protect the integrity of section 355, the provision that specifically dealt with nonrecognition at the shareholder level after a divisive transaction. The change unintentionally made it more difficult for the government to apply the reorganization provision to liquidation/reincorporation transactions. Eventually, the government used its ingenuity to get around the literal requirement of "substantially all." See B. BITTKER & J. EUSTICE, *supra* note 49, at ¶ 14.16. See also *infra* note 76 and accompanying text.

53. Section 361(a) provides for nonrecognition at the corporate level after a reorganization: "No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property in pursuance of the plan of reorganization solely for stock or securities in another corporation a party to the reorganization." I.R.C. § 361(a). If the corporation receives non-stock consideration, any gain is recognized unless "the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization" *Id.* at § 361(b)(5)(A).

54. Section 354(a)(1) permits nonrecognition of a shareholder level realized gain after an acquisitive reorganization: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." *Id.* at § 354(a)(1).

Section 355(a)(1) contains a similar nonrecognition allowance after a divisive transaction: "If a corporation . . . distributes to a shareholder, with respect to its stock, or distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation . . . which it controls immediately before the distribution . . . then no gain or loss shall be recognized" *Id.* at 355(a)(1). Note that nonrecognition is available under section 355 even when the distribution is not made pursuant to reorganization (within the meaning of section 368(a)(1)(D)). See *id.* at § 355(a)(2)(C). See also *infra* note 146.

55. See I.R.C. 368(a)(1)(A)-(G). See also *supra* note 7.

56. See *supra* note 5.

57. See *supra* notes 8-10.

58. See *supra* note 11.

terized as ordinary income.⁵⁹ Consequently, if the government succeeded in classifying the liquidation/reincorporation as a reorganization, the distribution of assets was automatically treated as ordinary income rather than as capital gain.⁶⁰ The shareholder's amount of realized gain in the liquidation part of the transaction still limited the amount of income subject to tax, but the income characterization was the same as the dividend income characterization.

B. Technical Difficulties

To classify the liquidation/reincorporation transaction as a reorganization, the government had to satisfy both the literal requirements of the statute as well as the judicial common law doctrines that evolved in conjunction with the reorganization provisions of the Code.⁶¹ Therefore, although the transaction may have fallen within the literal requirements of the (D) reorganization provisions, the common law requirements still had to be met to tax the shareholder under section 356. As previously noted, the government met with much success utilizing the (D) reorganization provision.⁶²

The 1939 Code defined the type (D) reorganization as "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the

59. The early cases suggested that the boot distribution was automatically characterized as ordinary income. See *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). In establishing the automatic dividend rule, the *Bedford* Court held that a "distribution, pursuant to a reorganization, of earnings and profits has the effect of a distribution of a taxable dividend. . . ." *Id.* at 292. Therefore, dividend treatment was immediately triggered if the distributing corporation had earnings and profits at the time of the distribution. Later cases, however, used the standards of section 302 relating to redemptions to determine the character of the boot dividend. See *Wright v. United States*, 482 F.2d 600, 610 (8th Cir. 1973) (promissory note received by a taxpayer in connection with a corporate reorganization was not equivalent to a dividend). See also *supra* note 11.

60. Characterization was the center of the dispute because capital gains were taxed at a much lower rate prior to 1986. See *supra* note 7 and accompanying text.

61. Historically, the courts have required reorganization transactions to satisfy three judicial doctrines: the business purpose requirement, the continuity of proprietary interest requirement, and the continuity of business enterprise requirement. The business purpose requirement originated in *Gregory v. Helvering*, 293 U.S. 465, 470 (1935), and the continuity of proprietary interest requirement developed in *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-40 (2nd Cir. 1932). The origin of the business enterprise requirement, on the other hand, is not really known; it appeared prior to the 1954 Code. See *Lynch, The Role of The Continuity of Business Enterprise Requirement in Liquidation-Reincorporation* 35 TAX LAWYER 737 (1982). See also *Treas. Reg. § 1.368-1(b)-(d)* (1987).

62. See *supra* notes 26-27 and accompanying text.

assets are transferred.”⁶³ When drafted, this provision was not intended to apply to a liquidation/reincorporation transaction.⁶⁴ Not surprisingly, there were several difficulties associated with applying the statute to this type of a transaction. These difficulties continued even after the passage of the 1954 Code because the one relevant change made by the 1954 Code aimed to protect the integrity of the divisive type of transaction, rather than to address the liquidation/reincorporation transaction.⁶⁵

1. The Transfer of Assets Requirement

The transfer of assets statutory requirement presented the first difficulty with fitting the liquidation/reincorporation transaction within the (D) reorganization provision. To qualify as a (D) reorganization, there must be a transfer of part of the assets of one corporation to *another* corporation.⁶⁶ If structured as a classic liquidation/reincorporation with the liquidation occurring first, and with the shareholders then responsible for transferring the assets to the new corporation, then the transaction did not satisfy the statute’s literal language.⁶⁷ In most situations, the reorganization provision would not apply. Strict adherence to the statutory prescription in the reorganization provisions has always been the rule rather than the exception.⁶⁸ In the liquidation/reincorporation context, however, when the government argued for reorganization treatment, a more liberal interpretation of the language in the statute prevailed.⁶⁹

To convince the courts that the liquidation/reincorporation

63. I.R.C. § 112(g)(1)(D) (1939). *Cf. supra* note 25.

64. The 1924 set forth the first (D) reorganization provision, and the legislative history indicates that the provision’s purpose was to provide reorganization treatment for divisive transactions. *See* H. R. REP. NO. 179, 68th Cong., 1st Sess. 16 (1924); S. REP. NO. 398, 68th Cong., 1st Sess. 17-18 (1924); 65 Cong. Rec. 2429 (statement of Representative Green). The provision remained the same in the 1939 Code but was recodified to section 112(g)(1).

65. *See infra* text accompanying note 75.

66. I.R.C. § 368(a)(1)(D).

67. If structured as a sale of assets followed by a liquidation of the transferor, the liquidation/reincorporation transaction fell within the literal language of the statute. Problems arose with respect to fitting the transaction within the literal language of the statute only when the transaction was structured in various other forms such as the one outlined in the text.

68. *See* Treas. Reg. 1.368-1(b) (1987). *See also* Westin, *supra* note 17, at 1003 (discussing as early as 1924 the Congressional mandate for strict adherence to the reorganization statutes). This philosophy accords with the general belief that tax relief provisions, such as nonrecognition provisions, should be strictly construed against the taxpayer.

69. *See supra* note 61.

transaction should be recast as a type (D) reorganization, the government argued that the series of steps in the liquidation/reincorporation transaction were part of an integrated plan. Under the "step transaction" doctrine, as it was known, courts assessed the entire transaction at the beginning and at the end, taking into account the objectives to be accomplished and the means employed to accomplish the objectives.⁷⁰ This approach allowed the courts to collapse the separate steps of the transaction into one step so that it appeared as though the transferor corporation actually transferred the assets to the corporation controlled by the same shareholders. The step transaction aimed to prevent taxpayers from recasting clearly taxable transactions into a series of non-taxable transactions. Most courts accepted the doctrine and allowed the transaction to be analyzed under the (D) reorganization provision even though the actual transaction did not fit within the literal language of the statute.⁷¹

2. The Substantially All Requirement And Continuity of Business Enterprise

The "substantially all" requirement, added by the 1954 Code, posed the second problem associated with the application of the (D) reorganization provision in the liquidation/reincorporation context.⁷² This requirement, contained in section 354(b), provided that the transferor corporation must transfer substantially all of its assets to the transferee corporation to qualify as a non-divisive (D) reorganization.⁷³

The purpose of the substantially all requirement was to withdraw beneficial reorganization treatment from transactions that Congress believed involved true economic gain.⁷⁴ Congress in-

70. Nicholson, 335-2nd T.M., *Liquidation-Reincorporation* at A-3 (1989) (citing, *Heller v. Commissioner*, 2 T.C. 371 (1943), *aff'd*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945)).

71. See *Liddon v. Commissioner*, 230 F.2d 304, 309 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52, 58 (2nd Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Survaunt v. Commissioner*, 162 F.2d 753, 758-59 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1947); *Lesser v. Commissioner*, 26 T.C. 306, 312-14 (1956); *Pebble Springs Distilling Co. v. Commissioner*, 23 T.C. 196, 201-02 (1954), *aff'd*, 231 F.2d 288 (7th Cir. 1956), *cert. denied*, 352 U.S. 836 (1956); *Heller v. Commissioner*, 2 T.C. 371, 383-84 (1943), *aff'd*, 147 F.2d 376 (9th Cir. 1945), *cert. denied*, 325 U.S. 868 (1945). The cases that refused to apply the doctrine include, *United States v. Arcade Co.*, 203 F.2d 230, 235 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953) and *Henricksen v. Braicks*, 137 F.2d 632, 636 (9th Cir. 1943).

72. I.R.C. § 354(b) (1954).

73. *Id.*

74. *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 40 (4th Cir. 1965).

tended the requirement to prevent a circumvention of section 355, which specifically dealt with divisive transactions. It also unintentionally reduced the effectiveness of the (D) provision as a weapon to attack the liquidation/reincorporation transactions.⁷⁵ The substantially all requirement's ultimate effect was insignificant because again the courts allowed the government to avoid the literal meaning of the statutory language. The courts held almost unanimously that the requirement applied only to the actual operating assets of the business.⁷⁶

Satisfaction of the statutory requirement, however, did not end the court's inquiry because an independent common law requirement had to be satisfied as well. The continuity of business enterprise requirement mandates that a significant portion of the transferor's assets be transferred to and used by the transferee corporation.⁷⁷ Although essentially the same as the statutory substantially all requirement, the courts have held that the two requirements are separate.⁷⁸ The Ninth Circuit stated that the common law requirement does not apply at all when the reorganization provisions are applied to a liquidation/reincorporation transaction.⁷⁹ According to the court, the focus should instead be restricted to the technical requirements of the reorganization provisions.⁸⁰

Thus, this independent common law requirement is not a significant obstacle to application of the reorganization provisions to a liquidation/reincorporation transaction. The lenient approach with respect to this common law requirement's application, however, injects an element of uncertainty into the reorganization analysis as a whole because this approach does not apply outside of the

75. See B. BITTKER & J. EUSTICE, *supra* note 49, at ¶ 14.16. See also *supra* note 52.

76. See *Smothers v. United States*, 642 F.2d 894, 900-01 (5th Cir. 1981) (15% of net worth transferred satisfied substantially all requirement); *Moffat v. Commissioner*, 42 T.C. 558, 578-81 (1964), *aff'd*, 363 F.2d 262 (9th Cir. 1966) (finding that "substantially all" refers to operating assets); *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 309 (1964) (the substantially all requirement was met even though only 51% of the total assets were transferred to the transferee corporation).

77. See *Atlas Tool Co. v. Commissioner*, 614 F.2d 860, 871 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980); *Lewis V. Commissioner*, 176 F.2d 646, 650 (1st Cir. 1949).

78. See *Lynch*, *supra* note 61, at 761. See also *Workman v. Commissioner*, 46 T.C.M. (P-H) ¶ 77, 378 (1977).

79. *Rose v. United States*, 640 F.2d 1030, 1036, n.11 (9th Cir. 1981), *aff'g* 1979-1 USTC ¶ 9194, 43 AFTR 2d 79-454 (W.D. Wash. 1978). This statement was merely dictum because the issue was not litigated. *But see Atlas Tool Co. v. Commissioner*, 614 F.2d 860, 866 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980) (both statutory and nonstatutory requirements apply).

80. *Rose*, 640 F.2d at 1036 n.11; *Lynch*, *supra* note 61, at 738.

liquidation/reincorporation context.⁸¹

3. The Control Requirement And Continuity of Interest

The statutory control requirement, included in the definition of a (D) reorganization, posed the third problem that often arose in applying the reorganization provision to a liquidation/reincorporation transaction. Prior to 1984, the control requirement provided that, after the transfer of assets, the shareholders or the transferor corporation, or any combination thereof, had to own at least eighty percent of the combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock.⁸²

This requirement caused difficulty for the government because the courts interpreted statutory control strictly.⁸³ Problems arose because shareholders would structure a liquidation/reincorporation transaction so that, after the reincorporation, the original stockholders and the transferor corporation owned slightly less than the 80% required by the statute.⁸⁴ By structuring the transaction this way, the shareholders could avoid reorganization treatment to achieve essentially the same benefits of a liquidation/reincorporation.

In 1984, Congress amended the definition of control for a non-divisive (D) reorganization to reduce the control requirement from eighty percent to fifty percent and to permit the use of the attribution rules to satisfy this requirement.⁸⁵ Congress specifically in-

81. Lynch, *supra* note 61, at 738.

82. I.R.C. § 368(c) (1954).

83. See Krasner, *supra* note 17, at 894-95.

84. See, e.g., Breech v. United States, 439 F.2d 409, 410 (9th Cir. 1971) (court found no (D) reorganization because former shareholders of the transferor corporation owned 20% of the new corporation, and a corporation which was in turn 75% owned by the shareholders of the transferor corporation owned the remaining 80%); Berghash v. Commissioner, 43 T.C. 743, 755-56 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966) (no (D) reorganization when the shareholder of transferor only owned 50% of the new corporation, and a key employee of the transferor owned the other 50%); Gallagher v. Commissioner, 39 T.C. 144 (1962) (shareholders avoided reorganization treatment by shifting proprietary interests to include key employees in the corporation, so the ownership percentage of the transferor's active shareholders after the reincorporation amounted to only 73%). *But cf.* Stanton v. United States, 512 F.2d 13, 17 (3d Cir. 1975), *rev'g* 371 F. Supp. 103 (E.D. Pa. 1974) (control requirement satisfied because wife who was not a shareholder of the transferor became a 50% shareholder in the transferee; court deemed the wife's stock a gift from her husband, the 100% shareholder of the transferor corporation).

85. Section 368(a)(2)(H) provides: "In the case of any transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, for purposes of determining whether such transaction qualifies under subparagraph (D) of paragraph (1), the term 'control' has the meaning given to such term by section 304(c)."

tended this change to expand the definition of the non-divisive (D) reorganization as a means of attacking the liquidation/reincorporation transaction.⁸⁶ As a result, the (D) reorganization provision became a stronger weapon for the government. At the same time, however, this change injected an element of inconsistency into the reorganization analysis because historically, the reorganization rules were applied narrowly to a limited number of legitimate business transactions.⁸⁷

In particular, this change created a potential conflict with the related common law continuity of proprietary interest doctrine. This judicially created continuity of proprietary interest requirement, like the continuity of business enterprise requirement, must be satisfied independently from the statute for the transaction to qualify as a reorganization. This requirement is similar to the control requirement in the statute because it requires generally that the transferor corporation or its shareholders retain a substantial proprietary interest in the enterprise after the reorganization is complete.⁸⁸

This common law requirement now conflicts with the statutory requirement, however, because the changes implemented by the 1984 Act allow the attribution rules to be used to satisfy the statutory control requirement, although these rules cannot be used to satisfy the common law continuity of interest requirement. In other words, the indirect ownership of stock violates the common law doctrine because the common law requirement still contains a direct ownership test.⁸⁹ This conflict between the statute and the

I.R.C. § 368(a)(2)(H). This new definition invokes the rules of section 304(c), which in turn invokes the attribution rules of section 318. The attribution rules generally require that certain stock owned by other family members, partnerships, estates or trusts, be attributed to a shareholder even though the shareholder does not actually own the stock directly. See I.R.C. § 318.

86. See H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 847 (1984).

87. See Westin, *supra* note 17, at 1003 (reorganization provisions expanded beyond their bounds to get at the liquidation/reincorporation transaction).

88. See B. BITTKER & J. EUSTICE, *supra* note 49, at ¶ 14.11. See also *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.) (no precise definition exists for determining whether the continuity of interest requirement has been satisfied; yet, the courts have determined that the interest must be a material interest, and it must be represented by a direct ownership of stock in the transferee corporation), *cert. denied*, 342 U.S. 860 (1951).

89. See *Helvering v. Bashford*, 302 U.S. 454, 458 (1938) (transferor corporation's shareholders lacked continuity of interest because they received the parent's stock rather than the subsidiary's); *Groman v. Commissioner*, 302 U.S. 82, 89-90 (1937) (no continuity of interest in a triangular transaction in which the transferors received stock in the transferee corporation's parent in exchange for their property). The Supreme Court has refused to permit indirect ownership of an interest to satisfy the common law continuity

common law requirement exists because of the inherent problems associated with applying a reorganization provision in a way in which it was never intended to apply.⁹⁰ Congress intended the reorganization provisions to provide relief for taxpayers in limited situations, and the separate common law doctrines helped to define the narrow situations in which the taxpayer could qualify for the preferential treatment afforded by these provisions.⁹¹

More importantly an expanded definition of the (D) provision also opened the door to taxpayers to circumvent one of the other reorganization provisions. Specifically, this newly expanded (D) provision could be used to circumvent the (C) reorganization provision.⁹² By definition, the (D) provision, like the (C) provision, includes asset transfers. By relaxing the (D) control requirement, the government has unintentionally provided reorganization treatment to a whole set of transactions that do not meet the strict eighty percent control requirement of section (C).⁹³ Thus, a taxpayer who would like to obtain reorganization treatment in an as-

of interest requirement. *See Pinellas Ice and Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933).

90. *See supra* note 28 and accompanying text. The inconsistencies that arise with respect to the common law requirement of a business purpose further support the misapplication of the reorganization provisions in the liquidation/reincorporation context. This requirement, which originated in *Gregory v. Helvering*, 293 U.S. 465 (1935), has not been applied consistently when the reorganization provision has been invoked to cover liquidation/reincorporation transactions. In some cases, the courts have considered the existence of a business purpose important; in other cases, they have held that the requirement is not significant. *See Breech v. United States*, 439 F.2d 409, 411 (9th Cir. 1971) (business purpose significant); *Berghash v. Commissioner*, 43 T.C. 743, 749 (1965) (business purpose significant), *aff'd*, 361 F.2d 257 (2d Cir. 1966). *But cf.* *Rose v. United States*, 640 F.2d 1030, 1036 (9th Cir. 1981) (business purpose insignificant in the liquidation/reincorporation context). *See also Gregory*, 293 U.S. at 470 (the continuation of the business and a business purpose were two separate requirements for reorganization treatment). *But see Liddon v Commissioner*, 230 F.2d 304, 308 (6th Cir.) (transferee's continuation of the business was itself sufficient to satisfy the business purpose requirement), *cert. denied*, 352 U.S. 824 (1956). *See also Lewis v. Commissioner*, 176 F.2d 646, 650 (1st Cir. 1949) (court rejected argument that a transaction was not a reorganization because it lacked a corporate business purpose).

91. *See generally Lynch, supra* note 61, at 741-42; *Nunnallee, supra* note 17, at 1; *Westin, supra* note 17, at 998-99.

92. Section 368(a)(1)(C) defines the (C) reorganization as follows:

[T]he acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded.

I.R.C. § 368(a)(1)(C). *See infra* text accompanying note 143.

93. *See* I.R.C. §§ 368(a)(1)(C), 368(a)(2)(H).

set transfer transaction can avoid the more exacting contours of subsection (C).

This result illustrates one more problem associated with using the (D) reorganization provision to combat the abuses of a transaction to which the provision was never intended to apply. Although the government's use of section (D) in the liquidation/reincorporation context has been understandable (taking into account the history of legislative inaction in this area), analysis demonstrates that the use of this provision in the liquidation/reincorporation area has created a double-edged sword.

IV. THE TAX REFORM ACT OF 1986

A. *The Impact of the Act*

The Tax Reform Act of 1986⁹⁴ increased the potential for abuse under the (D) reorganization provision and, at the same time, reduced the usefulness of the provision as a weapon against the liquidation/reincorporation transaction. The changes imposed by the 1986 Act were not aimed specifically at the (D) reorganization provision or at the abuses associated with the liquidation/reincorporation transaction, although two of the changes had a significant impact on both.

The 1986 Act dramatically reduced the number of situations in which the transaction can still be used to circumvent the normal dividend distribution rules. Not surprisingly, these changes did not solve all of the problems associated with the liquidation/reincorporation transaction. Three limited situations still exist in which taxpayers may use the transaction to obtain the preferential tax treatment associated with an exchange distribution and to avoid the normal dividend distribution rules.⁹⁵ In the first situation, however, the usefulness of the reorganization provision as a weapon for the government has been eliminated. In the other two situations, the reorganization provision still fails to address all of the abuses associated with the transaction.⁹⁶ Indeed, the reorganization provision's reduced effectiveness as a weapon against the liquidation/reincorporation transaction was also related to the changes imposed by the 1986 Act.⁹⁷

To illustrate this point, the two changes of the 1986 Act affecting

94. Tax Reform Act of 1986, Pub. L. No. 99-514 § 701, 100 Stat. 2320 (1986). See *supra* note 7 (brief discussion of the 1986 Act's impact on the treatment of capital gains).

95. See *infra* notes 109-31 and accompanying text.

96. See *infra* notes 109-19 and accompanying text.

97. See *infra* note 119 and accompanying text.

the liquidation/reincorporation transaction will be considered. In addition, the new tax consequences associated with a normal dividend distribution and a liquidation/reincorporation transaction will be compared in light of several factors that can affect a particular transaction.⁹⁸ The reorganization provision will then be applied in each of the three situations to demonstrate that it is not an effective weapon for the government to use in combatting the abuses of the liquidation/reincorporation transaction.⁹⁹

B. The Changes Imposed by the Act

1. The Repeal of The Capital Gain Deduction

The first change of the 1986 Act that affected the liquidation/reincorporation transaction was the repeal of the capital gain deduction. The repeal of this deduction eliminated the rate differential for taxing ordinary income and capital gains.¹⁰⁰ This change reduced the shareholder's incentive for structuring a distribution as an exchange distribution rather than as a normal dividend distribution because capital gain and ordinary income are now taxed at the same rate.¹⁰¹ Some incentive to structure the distribution as an exchange distribution in order to obtain the capital gain treatment of the income still exists when shareholders have significant capital losses.¹⁰² In this situation, it is still important to have the distribution characterized as capital gain because capital losses can be offset only by capital gains.¹⁰³ In all other situations with respect to all types of distributions, however, the characterization issue has been equalized.¹⁰⁴

98. See *infra* note 108 and accompanying text.

99. See *infra* notes 109-31 and accompanying text. One commentator suggests that the remaining advantages associated with the liquidation/reincorporation transaction can still be attacked under the reorganization provisions. See Krasner, *supra* note 17, at 895. The situations described in Part C of this Article, however, will show that the reorganization provision is no longer an effective weapon to combat the remaining abuses associated with the liquidation/reincorporation transaction.

100. I.R.C. § 331(a). See also *supra* note 4.

101. *Id.*

102. *Id.*

103. See I.R.C. § 1211(a).

104. See *supra* note 7. The Jenkins-Archer Proposal, recently passed by the House, proposes to restore a capital gains cut to the Code. This proposal, however, would not affect the long term structure of the Code because it would only exist for a very limited duration even if eventually passed by the Senate. See 44 TAX NOTES 1303 (1989).

2. The Imposition Of A Corporate Level Tax: Repeal of The General Utilities Doctrine

The second change of the 1986 Act impacting on the liquidation/reincorporation transaction was the imposition of a corporate level tax on liquidating and non-liquidating distributions of appreciated assets.¹⁰⁵ This change also reduced the shareholder's incentive for structuring a distribution as an exchange distribution rather than as a normal dividend distribution. It did so because the cost of the corporate level tax has the potential to negate the benefit of stock basis recovery that is associated with an exchange transaction.¹⁰⁶

This corporate level tax also is imposed on normal dividend distributions of appreciated property and thus has the potential to increase the cost of a dividend distribution as well as an exchange distribution.¹⁰⁷ In spite of the exchange treatment of a liquidation, however, there is a larger potential to trigger a significant corporate level tax because all of the assets are distributed in a liquidation. If a significant corporate level tax will be triggered by liquidating the entire corporation, then it may make more sense for shareholders to withdraw only the liquid assets in a dividend distribution.

C. The Three Situations in which the Liquidation/Reincorporation Transaction Can Still Be Used to Circumvent the Normal Dividend Rules

The actual tax consequences of any transaction involving a distribution of a corporation's assets will depend on several factors, including the shareholder's stock basis, the basis of the corporate assets, the existence of any capital losses at the shareholder level,

105. See I.R.C. §§ 336(a), 311(b). These two sections directly repeal the *General Utilities* doctrine. Section 336(a) provides that "gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value." I.R.C. 336(a). See *supra* note 41 (further discussion of the *General Utilities* doctrine).

106. The cost of the corporate level tax is another factor considered, when determining whether the stock basis recovery provided in a liquidation transaction is large enough to limit the transaction's total amount of tax below the amount of tax that must be paid in a dividend distribution.

107. Cf. I.R.C. § 311(b) and I.R.C. § 336(a). Section 311(b) provides:

If a corporation distributes property . . . to a shareholder in a distribution to which subpart A applies, and the fair market value of such property exceeds its adjusted basis . . . then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

I.R.C. § 311(b).

and the existence of any net operating losses at the corporate level. The aforementioned changes in the 1986 Act had an impact on the interplay of these factors in the liquidation/reincorporation type of transaction. They also reduced the number of situations in which the transaction could be used to circumvent the normal dividend distribution rules.¹⁰⁸ As previously indicated, however, the changes did not completely eliminate all the situations in which the transaction can still be used to avoid the dividend distribution rules. In three limited situations, the transaction can still be used as a tax avoidance.

1. High Basis Assets and High Basis Stock

The first situation, in which the liquidation/reincorporation transaction still could be used by taxpayers to withdraw assets from a corporation and to avoid the normal dividend distribution rules, occurs when shareholders have a high basis in their stock and the corporate assets have a high basis. In this situation, the high basis in the stock would limit the amount of income recognized by the shareholders in the liquidating distribution, minimizing any realized gain.¹⁰⁹ Because this distribution would be treated as an exchange distribution, the shareholder's adjusted basis in the stock would offset the amount of income realized in the distribution.¹¹⁰ The amount of income subject to tax at the shareholder level would be kept to a minimum. Even though this income would no longer be taxed at a preferential capital gain rate, the benefit derived from the recovery of the high stock basis would make the exchange distribution more attractive than a normal dividend distribution because all of the income in a normal dividend distribution would be subject to a shareholder level tax.¹¹¹

The high basis in the corporate assets is important in this situation because of the new corporate level tax that is imposed on corporate distributions of appreciated assets.¹¹² The high basis in the corporate assets would have an effect similar to that of the high basis in the stock because the corporate liquidation provision al-

108. For a discussion of the specific situations in which the liquidation/reincorporation transaction can still be used to obtain preferential tax treatment, see *infra* notes 109-31 and accompanying text.

109. *Id.*

110. See I.R.C. § 331(a).

111. Cf. I.R.C. § 331(a) and § 301(a).

112. In either type of distribution of appreciated assets, the amount of gain subject to tax is equal to the difference between the fair market value of the asset distributed and the adjusted basis of the asset. I.R.C. §§ 311(b), 336(a).

lows a similar offset of the amount realized in the distribution for the adjusted basis in assets.¹¹³ As a result, the amount of tax imposed at both the corporate and shareholder levels in the exchange distribution could be kept to a level below the amount of tax that would be imposed on a normal dividend distribution of just the liquid assets.¹¹⁴ Under these circumstances, it would make more sense for the shareholders to liquidate the entire corporation to obtain the liquid assets rather than to withdraw only the liquid assets as a dividend.¹¹⁵

The reorganization provision is no longer useful for the government as a weapon against the abuse of the transaction under this set of circumstances. A section 356 boot distribution in this situation now receives the same or even better treatment than the exchange distribution. The boot distribution receives a similar offset by the stock basis to limit the amount of income recognized at the shareholder level.¹¹⁶ The high basis in the shareholder's stock offsets the amount of income recognized by the shareholder in exactly the same way it does in an exchange transaction.¹¹⁷ At the corporate level, the reorganization rules provide for complete nonrecognition, so no corporate level tax is imposed on the transaction.¹¹⁸ Thus, under this set of circumstances, the liquidation/reincorporation transaction still could be used to circumvent the normal dividend distribution rules. The net result is that the (D) provision would produce the same, if not better, results for the taxpayer.¹¹⁹

2. Capital Losses and a Small Corporate Level Tax

The second situation, which may still permit taxpayers to cir-

113. See I.R.C. § 336(a).

114. This result would not occur, however, in a dividend distribution because the dividend rules do not allow the shareholder to use stock basis to offset the amount of income received in the dividend distribution. See I.R.C. § 301.

115. This same result occurs even if the amount of liquid assets to be withdrawn is fairly small because the high basis in the stock and the assets significantly limits the amount of income subject to tax below the amount of liquid assets that would be subject to tax under the dividend rules if the transaction were structured as a normal dividend distribution rather than as an exchange distribution.

116. See I.R.C. § 356(a).

117. Cf. I.R.C. §§ 356(a), 331(a).

118. See I.R.C. § 361(a).

119. Under these circumstances if the basis in the corporate assets equalled their fair market value, the results of a liquidation/reincorporation transaction would be the same under the reorganization provision. In the majority of cases in which the basis in the corporate assets is high, but not equal to fair market value, treating the transaction as a reorganization would provide more preferential tax treatment for the taxpayer because the nonrecognition treatment provided by the reorganization provision would completely shelter all of the corporate level tax. Cf. I.R.C. §§ 336(a) and 361(a).

cumvent the normal dividend rules by using the liquidation/reincorporation transaction, occurs when the shareholders have significant capital losses that can be used to offset the capital gain recognized at the shareholder level.¹²⁰ This situation also requires a high basis in the corporate assets which can be used to offset the corporate level gain realized in the exchange distribution. The benefits associated with this situation can only be achieved if the corporate level tax can be kept below the total amount of tax that would have to be paid by the shareholders in a dividend distribution of the liquid assets.¹²¹ The liquidation/reincorporation transaction will be useful here only if the corporate level tax is kept to a minimum so that it will not negate the benefits associated with the offset of the shareholder level gain provided by the capital losses.

In contrast to the first situation, however, the government still could use the reorganization provision to eliminate one of the abuses of the transaction in this situation. The government could attack the abuse associated with the offset provided by the shareholder's capital losses by recharacterizing the distribution as ordinary income under section 356(a).¹²² This would render the shareholder's capital losses useless.¹²³

In addition, the abuse of a step-up in the basis of the reincorporated assets might be attacked by applying the reorganization provision in this situation. This abuse would exist, however, only if a net operating loss offset a significant corporate level gain.¹²⁴ In this situation, if the transaction were not treated as a reorganization, the corporate assets would receive a step-up in basis.¹²⁵ If the reorganization provision applied, on the other hand, then the corporate level gain would be afforded nonrecognition treatment, and the as-

120. See I.R.C. § 1211(a).

121. If the corporate level tax will be increased significantly by distributing all of the corporate assets, then it may not make sense to liquidate, even though the shareholder level tax could be avoided because of the offset provided by the capital losses. A net operating loss could also be used to offset the corporate level tax instead of a high basis in the corporate assets. See *infra* text accompanying notes 128-31.

122. See *supra* note 11.

123. See I.R.C. §§ 356(a)(2), 1211(a). If a net operating loss were used in this situation to offset the corporate level gain, instead of a high basis in the corporate assets, then the reorganization provision would allow the government to attack the step-up in basis achieved by the liquidation transaction. See *infra* notes 128-31 and accompanying text.

124. If a high basis in the corporate assets offset the corporate level gain, then no potential to significantly step-up the assets' basis would exist.

125. See I.R.C. § 334(a). Under section 334(a), the step-up in basis occurs upon liquidation because gain is recognized in the exchange transaction. Accordingly, the basis of property in the hands of the distributee is the fair market value of such property at the time of the distribution. *Id.* Upon reincorporation, the corporation takes a transfer basis in the assets. *Id.* at § 351(a).

sets would not receive a step-up in basis.¹²⁶ The reorganization provision could not reach one benefit derived by the taxpayer in the liquidation/reincorporation transaction: the benefit associated with the recovery of the shareholder's stock basis. This benefit is unreachable because both the boot distribution rules and the exchange distribution rules allow the same type of offset.¹²⁷

3. Net Operating Losses and High Basis Stock

The third situation in which the liquidation/reincorporation transaction still could be used by taxpayers to circumvent the dividend distribution rules occurs when the shareholders have a high stock basis to limit the amount of income at the shareholder level, and the corporation has a net operating loss at the corporate level to offset the amount of gain realized at the corporate level. In this situation, the exchange distribution provides more favorable tax treatment than a dividend distribution because the recovery of the stock's high basis reduces the amount of income subject to tax below the amount of liquid assets that would be subject to tax in a dividend distribution.¹²⁸ In addition, the net operating loss at the corporate level offsets any gain realized upon liquidation.¹²⁹ If the corporate level gain is significant, then the corporate assets will receive a significant step-up in basis so that upon reincorporation, future depreciation deductions may flow from the increased basis and generate additional tax savings.¹³⁰

The step-up in basis provides a significant benefit in this situation because the step-up occurs even though the offset provided by the net operating loss avoids the corporate level tax. This benefit does not accrue if the reorganization provision is applied to the transaction because the corporate level gain is sheltered by nonrecognition treatment, thus preventing a resulting step-up in basis.¹³¹

126. See I.R.C. §§ 361(a), 362(a).

127. See I.R.C. §§ 356(a), 331(a). This problem existed before the 1986 Act, and the reorganization provisions have never adequately addressed it.

128. See I.R.C. § 331(a).

129. See I.R.C. § 336(a).

130. The step-up in basis will not be significant, however, if the assets already have a high basis prior to the liquidation/reincorporation transaction.

131. I.R.C. § 362(a).

V. REPEAL OF THE (D) REORGANIZATION PROVISION

A. *The (D) Reorganization Provision In The Liquidation/Reincorporation Context*

1. An Ineffective Weapon For The Government

The changes implemented by the 1986 Act curtailed the continued usefulness of the (D) reorganization provision with respect to the abuses of the liquidation/reincorporation transaction. The reduction in the number of situations in which the transaction can still be used affected this result. Yet, the reorganization provision has lost much of its vitality even in the limited situations in which the transaction can be used.¹³²

As the preceding analysis demonstrates, the government still can use the reorganization provision to attack the abuses of the liquidation/reincorporation transaction in only two remaining situations.¹³³ Yet, even in these two very limited situations, the reorganization provision does not address all of the abuses associated with the transaction.¹³⁴ For example, the dividend within gain limitation of section 356(a) provides the biggest downfall to applying the reorganization provision to the liquidation/reincorporation transaction. The liquidation provision provides this similar gain limitation mechanism, which allows taxpayers to use their stock basis to offset the amount of income recognized in a reorganization transaction.¹³⁵ Although the reorganization provision can still combat part of the abuse, the most serious problem regarding the inclusion of the correct amount of income in the distribution remains unresolved.¹³⁶

2. The Taxpayers Use Of The (D) Provision Against The Government

The other significant problem associated with the (D) reorganization provision is that now it can be used by taxpayers against the government in situations unintended by Congress. This problem began in 1984 when Congress reduced the control requirement for

132. See *supra* notes 108-31 and accompanying text.

133. See *supra* notes 120-31 and accompanying text.

134. *Id.*

135. Cf. I.R.C. §§ 356(a) and 331(a).

136. Because the characterization issue has been equalized with respect to all types of distribution, except in cases involving capital losses, today the major abuse associated with the liquidation/reincorporation transaction is the limitation on the amount of income included in the distribution.

non-divisive (D) reorganizations.¹³⁷ This amended definition of control expanded the (D) provision's scope so that the government could use the provision more effectively as a weapon against abusive liquidation/reincorporation transactions.¹³⁸ At the same time, however, this change opened the door for taxpayers to circumvent the restrictive eighty percent boot consideration rule in the type (C) reorganization provision because the (D) provision, which only requires at least fifty percent control, covers many of the same asset transfers as the (C) provision. Essentially, a taxpayer can now more easily tailor an acquisitive transaction as a reorganization and avoid the more exacting requirements of the (C) provision.¹³⁹

The changes in the 1986 Act that impacted on the liquidation/reincorporation transaction reversed the arguments in the liquidation/reincorporation context.¹⁴⁰ This role reversal compels the taxpayer to argue for reorganization treatment and the government to argue that the transaction is taxable. This bizarre result will occur in the first situation discussed above when shareholders want to withdraw liquid assets from a corporation.¹⁴¹ Instead of withdrawing the assets in a normal dividend distribution, they will structure the transaction as a (D) reorganization to take advantage of the dividend within gain limitation provided by the boot distribution rules while avoiding the imposition of a corporate level tax. The government obviously would prefer to treat this transaction as a taxable one to collect the corporate level tax. The taxpayer, however, has the benefit of a large body of law, previously advanced by the government, that supports the application of the reorganization provision to this type of transaction.¹⁴²

The taxpayers use of the (D) reorganization provision in this situation circumvents the normal dividend distribution rules. Moreover, as previously noted, it also circumvents the type (C) reorganization because the taxpayers can take advantage of the reduced control requirement in the (D) provision.¹⁴³ This result is

137. See *supra* note 85 and accompanying text.

138. See *supra* note 86 and accompanying text.

139. See *supra* notes 92-93 and accompanying text. See also I.R.C. 368(a)(1)(A). The type (A) reorganization provision provides nonrecognition treatment for statutory mergers and has always been more liberal than the type (C) reorganization. The statutory merger provision is unique, however, because it is designed to cover transactions that are defined under state law. The other reorganization provisions cover transactions that are defined solely by the statute itself.

140. See *supra* note 119 and accompanying text.

141. See *supra* notes 109-19 and accompanying text.

142. See *supra* note 22 and accompanying text.

143. See *supra* text accompanying notes 92-93.

particularly disturbing because Congress did not originally intend the (D) provision to apply at all to non-divisive reorganizations.¹⁴⁴ As it stands now, section 368(a)(1)(D) provides a way for taxpayers to circumvent the dividend distribution rules as well as the other non-divisive reorganization provision that applies to asset transfers.

This problem could be eliminated by repealing the (D) provision. Repeal also would eliminate the inconsistency that has developed as result of the (D) provision's application in a manner unintended by Congress. Before the repeal can take place, however, it must be determined that the provision serves no other useful purpose.

B. Other Purposes Of The (D) Provision

The one transaction originally intended to be covered by the (D) reorganization provision was the divisive type of transaction.¹⁴⁵ Divisive transactions are still within the scope of the (D) reorganization provision, but now other independent provisions of the Code provide the same tax treatment for these types of transactions.¹⁴⁶ Thus, repeal of the (D) reorganization provision would have no significant effect.

The (D) provision's only other legitimate purpose would be to address some of the remaining abuses associated with the liquidation/reincorporation transaction. As previously indicated, however, the (D) provision does not address all of the abuses associated with the transaction even in the two limited situations in which it is partially helpful.¹⁴⁷

The situations in which the liquidation/reincorporation transaction still can be used to circumvent the dividend distribution rules could be dealt with more effectively by a rule dealing specifically

144. See *supra* note 64.

145. *Id.* This type of transaction is usually in the form of a spin-off, split-off, or split-up.

146. The 1954 Code effectively separated the divisive transaction from the scope of the reorganization provision, but it always remained within the language of section 368(a)(1)(D). If this section is repealed, the divisive reorganization can obtain the same nonrecognition treatment from section 355 alone or in conjunction with section 351. Nonrecognition at the shareholder level is not dependent upon a reorganization. See I.R.C. § 355(a)(2)(C). At the corporate level, if section 355 applies, section 355(c) permits nonrecognition by exempting the transaction from section 311(b). See I.R.C. § 355(c)(2). A discussion concerning these nonrecognition provisions is beyond the scope of this Article as is a discussion concerning the other reorganization provisions of the Code. For a discussion of the divisive type of transaction, see Simon & Simmons, *The Future of Section 355*, 40 TAX NOTES 291 (1988).

147. See *supra* notes 119-31.

with those three, very limited situations.¹⁴⁸ The necessity of such a rule would depend upon the frequency of these situations and the potential for significant abuse. A rule could prove superior to the reorganization provision because the latter has the potential to cause more problems than it can resolve.¹⁴⁹

VI. CONCLUSION

The 1986 Act significantly changed the role of the (D) reorganization provision. Prior to 1986, the (D) provision served primarily as a weapon for the government in combatting the abuses of the liquidation/reincorporation transaction. In 1986, this role was altered because the imposition of a corporate level tax on corporate distributions and the repeal of the capital gain deduction changed the tax consequences associated with the three different types of corporate distributions.

Specifically, these changes reduced the preferential tax treatment of the exchange distribution associated with the liquidation/reincorporation transaction. The exchange type of distribution is less attractive under the new law because both the imposition of the corporate level tax and the repeal of the capital gain deduction make the distribution more expensive than it was in the past. Consequently, fewer situations now exist in which the liquidation/

148. One commentator recently suggested several different ways to address the liquidation/reincorporation transaction outside of the reorganization provisions. *See* Westin, *supra* note 17, at 1007. These proposals could be restricted further to apply only in the four limited situations in which there is potential for abuse. *See also* Nunnallee, *supra* note 17, at 39. Nunnallee proposes a method to deal with the liquidation/reincorporation abuses outside of the reorganization provisions. His proposal suggests that distributions of appreciated property in a reincorporation transaction be taxed under section 301 so that these distributions would receive the same tax treatment as similar distributions made in redemption transactions and stock sale transactions under section 304. *Id.* The proposal does not, however, contain a rule that would determine when the dividend rules should apply and when liquidation rules should apply. Again, this type of rule could be restricted to the four limited situations in which there is still a potential for abuse.

149. The Senate Finance Committee's Subchapter C Revision Act of 1985 adopted a similar approach. The proposal in this Act effectively eliminated the (D) reorganization provision and altered the complete structure of the reorganization provisions so that the tax consequences at the corporate and shareholder levels were made completely independent of one another. At the corporate level, nonrecognition treatment was made dependent on meeting the requirements of a qualified acquisition of assets or stock; nonrecognition treatment at the shareholder level was dependent upon the receipt of stock as consideration in the transaction. Any boot received by shareholders in a "qualifying acquisition" was treated as a dividend, and there was no dividend within gain limitation to limit the amount of income recognized in the transaction. *See The Subchapter C Revision Act of 1985*, 99th Cong., 1st Sess. (1985).

reincorporation transaction can be used by taxpayers to circumvent the normal dividend distribution rules.

The reorganization transaction, on the other hand, is more attractive under the new law because the nonrecognition treatment provided by the reorganization provision shelters the corporate level tax. As a result, more situations will now arise in which taxpayers will want to use the reorganization provision to circumvent the normal dividend distribution rules and the exchange distribution rules.

The possibility of taxpayers using the (D) provision to avoid the normal dividend distribution rules in non-divisive transactions is particularly disturbing because the (D) reorganization provision was originally drafted to cover divisive types of transaction and was not intended to apply to non-divisive types of transactions. Since 1954, however, the divisive type of transaction has been effectively separated from the scope of the provision while treatment of the non-divisive transaction under the provision has been expanded. The expanded treatment of the non-divisive transaction occurred in 1984 so the provision could be used more effectively as a weapon by the government to attack the non-divisive liquidation/reincorporation transaction. Now, however, the expanded version of the (D) provision makes it easier for taxpayers to use in situations in which it was never intended to apply.

The repeal of the (D) provision would eliminate the potential for circumventing the other distribution rules in the Code and could do so without affecting the treatment of the divisive transaction currently within the provision's scope. The divisive type of transaction could be handled by applying other independent provisions of the Code. The few remaining abuses of the liquidation/reincorporation transaction could be addressed under a specific rule designed to apply in the three limited situations in which the transaction still may be used.