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Should General Utilities Be Reinstated to Provide Partial Integration of Corporate and Personal Income—Is Half a Loaf Better than None?

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I. INTRODUCTION

The *General Utilities* doctrine is the name given to the now largely defunct tax rule that a corporation does not recognize a gain or a loss on making a liquidating or nonliquidating distribution of an appreciated or depreciated asset

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to its shareholders. The roots of the doctrine, can be traced to a regulation promulgated in 1919 that denied realization of gain or loss to a corporation when making a liquidating distribution of an asset in kind. No regulatory provision existed which specified the extent to which realization would or would not be triggered by a nonliquidating distribution such as a dividend or a stock redemption. In General Utilities & Operating Co. v. Helvering, the Supreme Court adopted a nonrecognition rule for dividend distributions that are made in kind. In deference to that decision, the rule for nonrecognition of gain or loss on a liquidating or a nonliquidating corporate distribution of property in kind has been commonly referred to as the General Utilities doctrine. Congress codified the doctrine in the Internal Revenue Code of 1954 (the Code). With few exceptions, the original provisions of the Code provided that a distributing corporation did not recognize a gain or loss on making a distribution in kind.

Over the years, Congress adopted numerous exceptions to the general rule of nonrecognition of gain so that even before the Tax Reform Act of 1986 (TRA 1986) was adopted, recognition of gain had become the general rule and nonrecognition the exception for nonliquidating distributions. To a lesser extent, the General Utilities doctrine was worn away with respect to liquidating distributions as well. For example, both the depreciation recapture rules and LIFO recapture rules triggered recognition in liquidating or nonliquidating corporate distributions. With respect to nonliquidating distributions, by 1986 the general rule had become that a corporation recognized a gain on making a distribution of an appreciated asset (for example, as a dividend, a stock redemption, or a partial liquidation), and only in narrowly defined circumstances was gain not recognized. The General Utilities doctrine had been sufficiently eroded by 1986 that it was said that the "General" had been reduced in rank to a "Corporal."

Subject to transitional rules and delayed effective dates for certain small corporations, under the amendments in TRA 1986, Congress requires recognition of gain for all corporate distributions of appreciated property, but provides nonrecognition of gain or loss for: 1) Certain distributions made in liquidation

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2. Treas. Reg. § 45, art. 547 (1919) provided: "No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition."
4. Id. at 204.
5. Sections 311, 336, and 337 of the Code were the principal provisions that dealt with the General Utilities doctrine. Congress repudiated most of the doctrine in 1986 when it amended those provisions in the Internal Revenue Code of 1986. See infra text accompanying notes 10-17.
7. I.R.C. §§ 311(b), 336(b), 337(f), 1245, 1250 (1986) (noting the Code as it existed immediately prior to the adoption of TRA 1986).
8. Id. § 311(d).
10. No gain is recognized by a corporation on distributing its own stock or its own debt instrument. Under § 1032 of the Code, a corporation does not recognize a gain or loss on the disposition of its own stock. I.R.C. § 1032 (1986). Neither does a corporation recognize a gain or loss on the sale or exchange of its own debt instrument for the face amount because that transaction is essentially one in which the corporation is borrowing funds and the distributee is merely a lender.
of a corporate subsidiary; \textsuperscript{11} and 2) for distributions made pursuant to a corporate division or reorganization. \textsuperscript{12} The post-TRA 1986 Code continues to preclude the recognition of losses on a nonliquidating corporate distribution of a depreciated asset. With a few exceptions, losses are recognized on a corporation's liquidating distributions. \textsuperscript{13} Thus, Congress has retained the \textit{General Utilities} doctrine for losses—at least as to nonliquidating distributions—but it has revoked the doctrine for gains.

TRA 1986 eliminated virtually all of the \textit{General Utilities} doctrine that applies to the recognition of gain. The question now becomes whether the doctrine should have been retained or even expanded. The justifications behind the \textit{General Utilities} doctrine and the reasons for its demise are worth examining because the battle over this doctrine may not be over. When the hearings in Congress were held to consider the repeal of \textit{General Utilities}, a number of witnesses testified that the doctrine should be retained for liquidating distributions of small, closely-held corporations, at least with respect to the distributions of capital and section 1231 assets. \textsuperscript{14} When, in TRA 1986, Congress required a corporation to recognize gain or loss on making a liquidating distribution of appreciated or depreciated property, it delayed the effective date of that provision for the liquidation of certain small, closely-held corporations that liquidate before 1989. \textsuperscript{15} This delayed effective date is available only to corporations that were: 1) in existence on August 1, 1986; and 2) from that date until liquidated had more than fifty percent (by value) of its stock held by ten or fewer "qualified investors."\textsuperscript{16}

\begin{enumerate}
\item Id. §§ 361, 368, 1032. The exceptions for reorganizations, corporate divisions, and liquidations of controlled subsidiaries are nonrecognition provisions (as contrasted to nonrealization) and, therefore, provision is made for carryover basis with regard to such transactions. Id. §§ 334(b)(1), 362; D. \textit{KAHN} & P. \textit{GANN}, \textit{supra} note 1, at 542. However, if the corporation issues its debt instrument at a discount, then it can enjoy deductions under the original issue discount rules over the term of the loan; and, conversely, if the debt is issued at a premium, the corporation will recognize income over the term of the loan; and, conversely, if the debt is issued at a premium, the corporation will recognize income over the term of the loan. \textit{See} B. \textit{BITTKER} & J. \textit{EUSTICE}, \textit{INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS}, 4.40-60 (5th ed. 1987); Treas. Reg. § 1.61-12(c). The deduction of income provided for debt issued at a discount or at a premium is a means of adjusting the interest deductible by the issuer and recognizable by the creditor to reflect the actual interest paid.
\item I.R.C. §§ 311(a) & 336(a) (1987).
\item TRA 1986, \textit{supra} note 6, § 633(d). This exception does not apply to a corporation whose value exceeds $10,000,000. TRA 1986 also requires that the amount of the nonrecognition provided by that provision be phased out when the value of the corporation exceeds $5,000,000. \textit{Id}. The delayed effective date also applies to certain other 1986 amendments that relate to corporate liquidations. For example, the delayed date also applies to prevent a liquidating corporation from recognizing a gain or loss on the sale of certain types of assets pursuant to a liquidation that is completed within a twelve-month period.
\end{enumerate}
persons. The delayed effective date provision of TRA 1986 neither prevents a liquidating corporation from recognizing ordinary gain or loss from the distribution of an asset; nor does it prevent the recognition of short-term gain or loss.

The concern over the application of a recognition requirement to a liquidating small corporation is likely to inspire further debate about whether the General Utilities doctrine or some modified version of that doctrine should be reinstated, especially for small corporations. Perhaps, the delayed effective date provision will be extended by Congress to apply after 1988, but, even if that is done, eventually Congress will have to face the question of whether the repeal of General Utilities was wise. A continuing discussion of the problem will keep it alive and may help Congress decide whether to bring back the doctrine or to fashion relief measures for some of the consequences of the 1986 repeal. It is noteworthy that in its current study of proposals for change to Subchapter C of the Code, the Treasury Department is contemplating proposing changes to the treatment of the General Utilities issue.

Also, the General Utilities doctrine has not been completely eliminated by Congress. As previously noted, remnants of the doctrine survive through the delayed effective date for certain small corporations and through the denial of realization for the loss that occurs on the nonliquidating distribution of a depreciated asset. So long as some portions of the doctrine are retained, tax policy issues concerning the doctrine continue to be relevant.

II. INTEGRATION

The thesis of this Article is grounded on the premise that, as a matter of good tax policy and in the absence of considerations of administrative burdens and politics, corporate and personal income taxes should be integrated so that the income of a corporation would be subjected to a single tax rate structure. For convenience, the integration of personal and corporate income taxes is

16. A "qualified person" is an individual, an estate, or certain types of trusts. TRA 1986, supra note 6, § 633(d)(6)(A). Stock ownership is determined by applying certain stock attribution rules that will attribute stock owned by an entity to its beneficiaries or owners, and will attribute stock from one family member to another. I.R.C. § 318 (1987). Congress intended to require that the ten or fewer persons who hold more than 50% in value of the corporation's stock have held that stock for at least five years. CONFERENCE REPORT ON THE TAX REFORM ACT OF 1986, H. R. REP. No. 841, 99th Cong., 2d Sess. II-206 (1986). A technical amendment may be necessary to effect that holding period requirement. See JOINT COMM. ON TAX., 100th CONG., 1st Sess. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 354 n.102 (1987) [hereinafter Blue Book].

17. Section 633(d)(2) of TRA 1986 excludes three types of gains and losses from the deferred date provision. One of the deletions is for "any gain or loss on a capital asset held for not more than 6 months." TRA 1986, supra note 6, § 633(d)(2)(B). The obvious purpose of this exception is to subject short-term capital gains and losses to the recognition requirements of the amended version of the Code. See Blue Book, supra note 16, at 352. However, as of January 1, 1988, the holding period requirement for long-term capital gains became more than one year rather than more than six months. I.R.C. § 1222 (1987). The spirit of the law would require the recognition of gain or loss for the distribution, after 1987, of an appreciated or depreciated capital asset that was held for one year or less, but the literal language of the statute requires recognition for the distribution of a capital asset only if it is held for six months or less. Id.


referred to hereafter simply as "integration." Integration has been advocated by a substantial number of public finance economists. Some forms of partial integration have been adopted by Canada, the entire European Economic Community, and virtually every major industrialized nation other than the United States. In the last fifteen years, there have been numerous proposals for the United States to adopt some form of integration. The House version of the bill that became TRA 1986 provided a small amount of dividend relief that constituted a gesture of acceptance of the desirability of integration. Despite this, Congress has failed to move towards integration. To the contrary, it has moved further away from integration by removing many of the previously available relief measures—such as the General Utilities doctrine—from the present unintegrated corporate tax.

Not everyone accepts the proposition that tax policy is better served by integration. For example, the late Professor Stanley Surrey rejected integration as resting on no more than tax theology. This article does not seek to add any new thoughts to the debate over integration, but rather, accepts the integrationist's view and focuses on whether that view leads to the conclusion that General Utilities should be reinstated. In order to determine the relevance of the integration concept to the General Utilities doctrine, it is necessary to understand the various reasons given by the integrationists for the adoption of that concept. Those reasons are set forth and briefly examined later in this Article. Before examining those reasons and the likely explanation for Congress’ rejection of integration, it will be helpful to consider the forms that integration can take.

21. See Nolan, supra note 14, at 100-01.
23. H.R. REP. No. 3838, § 311, 99th Cong., 1st Sess. 263 (1985) (providing a 10% dividend paid deduction) (available on microfiche at University of Iowa Law Library). In the Treasury Department's first recommendation to the President (Treasury I) containing the proposals that ultimately led to the adoption of TRA 1986, the Treasury recommended that a corporation be allowed a deduction for 50% of the amount of dividends that it paid. TREASURY DEPARTMENT REPORT TO THE PRESIDENT ON TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, VOL. 1 118-19 (Nov. 1984). This proposal provided a far more generous dividend relief than was proposed in the House bill. Neither of the proposals for dividend relief were adopted.
25. See infra text accompanying notes 31-69.
A. Forms of Integration and Dividend Relief

Integration can take a number of quite different forms, and the terminology that is employed by commentators in describing them is not uniform. This Article adopts what appears to be the more common terminology. Nevertheless, in the interests of clarity, many of the terms used herein are defined as they appear.

Integration can be designed to apply to all of a corporation’s income, whether retained or distributed, or it can apply only to distributed earnings. A system that is limited to distributed earnings is more accurately described as “dividend relief” rather than a form of integration. The purpose of dividend relief is to effect integration policies. Consequently, dividend relief systems commonly have been described as forms of integration. In this Article, they will be referred to as “partial integration” systems.

Integration could be accomplished by eliminating the corporate tax, allocating corporate income among the corporation’s shareholders, and taxing it directly to them as part of their personal income. This type of integration is referred to as “total” or “full” integration.

One means of total integration is to defer the tax on a corporation’s income until distributed to shareholders. Such a deferral would result in a lower tax burden on corporate earnings than on other income that is taxed in the year earned. Consequently, this approach would not be adopted unless the deferral were eliminated or mitigated by some means such as requiring the corporation to pay a withholding tax on its earnings, which would then be added to dividends paid to shareholders who would receive an income tax credit for the withheld tax. The following simplified example illustrates how this type of total integration would operate. In this example, there is no separate corporate income tax, but a corporation pays a withholding tax of thirty percent on its income.

Assume \( B \) is the sole shareholder of the \( X \) corporation. In year one, \( X \) earns \$10,000 of net income, and it makes no distributions to its shareholder. \( X \) pays a withholding tax of \$3000. In year two, \( X \) has no income or loss, and \( X \) distributes \$5000 to \( B \). \( B \) is treated as having received, as a dividend, the amount of corporate earnings that would produce \$5000 after the imposition of a thirty percent withholding tax. Thus, \( B \) will include \$7143 in his gross income which will be subject to his personal income tax rate. \( B \) is allowed a tax credit of \$2143—the amount of withholding tax paid by \( X \) on the \$7143 of its earnings that is deemed to have been distributed to \( B \)—against his income tax liability for year two. Thus, the amount distributed to \( B \) is grossed up to include the withholding tax paid by \( X \), and \( B \) is allowed a tax credit for the withholding tax previously paid by the corporation.


27. The \$7143 is the rounded off figure obtained from dividing the \$5000 of accumulated corporate earnings that \( B \) received by 70%. Another method for computing the amount of withholding tax that is attributable to the corporate distribution is to determine the fraction of retained earnings that are distributed to \( B \) and to multiply that fraction times the \$3000 of tax paid by \( X \) on its Year One earnings. Thus, \( 5/7 \)ths times \$3000 is \$2143 (the portion of the withholding tax that is attributable to \( B \)’s distribution).
A purer method of total integration is to allocate a corporation's income, losses, and other tax items among its shareholders at the end of a specified period, such as a taxable year, regardless of whether the income has been distributed or retained. This method, sometimes referred to as "pass-through total integration," operates in the familiar manner that is applied to "S" corporations and to partnerships. There are a number of administrative difficulties in employing this approach. For example, there are difficulties in allocating the corporation's income among shareholders holding different classes of stock representing different rights and priorities. Tiers of stock ownership by several corporations, and sales of stock during a taxable year raise difficult allocation questions. Difficult policy questions arise with respect to the proper treatment of shareholders who are nonresident aliens and those who are tax exempt entities. Despite these and other administrative problems, a 1977 Treasury Department study recommended the adoption of this form of integration. The administrative difficulties caused by "pass-through total integration" are so burdensome that it is neither likely nor desirable that total integration will be adopted in this country. If any comprehensive system of integration is ever adopted, it is more likely to be some form of partial integration.

Instead of subjecting corporate income to a single tax at the shareholder's personal tax rates, the separate corporate income tax could be retained, but the double tax imposition could be mitigated or eliminated entirely by providing some type of dividend relief. That is, the corporation could be allowed a deduction for all or some fraction of the dividend payments it makes; the corporation could be taxed at a lower rate on distributed income than it is on retained income; or the amount paid to a shareholder as a dividend could be grossed up for all or a fraction of the corporate tax attributable to the distributed income and the shareholder could be allowed a tax credit of an equal amount. These various forms of dividend relief often are referred to as "partial integration." They are distinguishable from "total integration" in that partial integration operates on distributed earnings only, whereas total integration operates on both retained and distributed earnings. This distinction is especially meaningful for the pass-through type of total integration that is similar to the Subchapter S provisions of the Code. In truth, there is no substantive difference between the withholding tax form of total integration and the imposition of a separate corporate tax with tax credits provided to shareholders who receive dividend payments, and for that reason the withholding tax approach may well be described as a form of partial integration.

A partial integration system need not impose a greater tax burden than is imposed by a total integration system. If the dividend relief is complete—for example, if the entire amount of a dividend is deductible or if the shareholder receives a tax credit for the entire amount of the corporate tax that was paid on the distributed income—the tax burden will be equal to that imposed by a

28. An "S" corporation is a corporation that successfully has elected to have taxes on it and its shareholders determined under Subtitle A, Chapter 1, Subchapter S of the Code. I.R.C. § 1361(a)(1) (1987). With only three exceptions, an "S" corporation does not pay federal income taxes, and its tax attributes (income, deductions, credits, and the like) are allocated among its shareholders and treated as if incurred directly by them. Id. §§ 1363(a), 1366.

29. BLUEPRINTS, supra note 22, at 68-75.
“pass-through system,” provided that the shareholder and the corporation are in the same tax bracket. However, the typical partial integration system that is proposed for this country or that has been adopted by a foreign country, does not provide complete dividend relief.30

B. The Case for Integration

Before considering the merits of an integrated corporate tax over the present unintegrated tax, it is useful to consider precisely what it is that an income tax system seeks to tax. The prevalent definition of income, as that term is employed in the income tax world, is the Haig-Simons definition. Haig-Simons defines income as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question.”31 Under this definition, the personal income tax can be viewed as a tax on the sum of the value of a taxpayer’s consumption in a taxable period plus the value of the increase in that taxable period of the taxpayer’s power to consume in the future. An income tax on savings, then, is a tax on consumption that will take place in the future.

The imposition of an income tax on savings creates a bias in favor of current consumption over savings that distorts spending choices. For example, if, in Year One, G earns a dollar of income which he spends in that year on personal consumption, he will receive a dollar’s worth of consumption in that taxable year and will pay an income tax on that one dollar. If, instead, G were to retain the dollar as savings and spend it on consumption in Year Ten, he will be taxed in Year One on a dollar’s consumption that he did not enjoy until Year Ten.32 The present value in Year One of the dollar’s worth of consumption that G had in Year Ten is substantially less than one dollar. To derive the maximum economic benefit from his taxed dollar, G would do better to spend it in the year earned rather than save it. That is not to say there is no incentive for G to save. The more one consumes, the more the utility derived from additional consumption will diminish. At some point, the utility of saving for future consumption, even given a tax bias, is greater than the utility of currently consuming another dollar.

30. See C. McLure, supra note 20, at 3-5; Nolan, supra note 14, at 100-01. McLure adopts a slightly different definition for the terms partial and total integration than are used herein.
31. H. SIMONS, PERSONAL INCOME TAXATION 50 (1938); see also HAIG, The Concept of Income, in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921), reprinted in AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION 54 (1959). The Haig-Simons definition is useful for exploring the general aims of the income tax system. It often is a starting point for those who advocate or employ a Tax Expenditure Budget concept, but the definition is not applied strictly. See BLUEPRINTS, supra note 22, at 22-23. The author believes that it would be a mistake to attempt to apply the Haig-Simons definition literally or inflexibly in determining the “neutrality” of specific income tax provisions. Many considerations (e.g. administrative costs) shape the determination of the base against which an income tax is applied and must be taken into account in determining whether a tax provision provides preferential treatment to certain taxpayers. The author hopes to explore this issue in detail in a later writing.
32. G can invest the dollar that he retains and earn income that will increase his ability to consume in the future. The increased future consumption does not fully compensate G for having been taxed on the retained dollar since the investment earnings also will be taxed. G will be taxed currently on the value of the dollar for future consumption. He also will be taxed on the increased consumption power that he derives from earnings produced by that invested dollar.
The taxation of the earnings derived from savings may be viewed as the cause of distortion in spending choices. Assume, for example, that a dollar invested today for a one year period will produce ten cents of income at the end of that period so that the investor will then have $1.10 to use for consumption. The present value of $1.10 of consumption to take place in one year, therefore, is one dollar. If $G$ earns one dollar of income in Year One, the taxation of that dollar reflects the present value of the $1.10 of consumption that it can provide $G$ in one year's time. However, the ten cents of earnings that the dollar produces over that year also is subjected to an income tax. Thus, the ten cents investment earnings is taxed twice. The taxation of the one dollar that $G$ saved in Year One represents a tax on the present value of $G$'s future consumption of that dollar plus a tax on his future consumption ability resulting from the income earned by that dollar.

Other considerations, such as the diminishing utility of additional current consumption, can outweigh this tax bias against savings. However this bias is a matter of concern especially when aggravated by inflation that also triggers a bias for current consumption. The discussion below explains how the concern over a tax bias against savings impacts on the desirability of an integrated tax system.

1. The Conduit View

Integrationists adopt the premise that a corporation is merely a fictional entity given a jural status for certain purposes. This entity actually represents the aggregation of investments by its shareholders.\(^33\) It is a relatively easy second step to conclude that the tax on the earnings from pooled savings\(^34\) should not be greater than the tax on earnings from savings that are not so pooled or are pooled through participation in a partnership.\(^35\) This conclusion rests both on a concern for horizontal and vertical equity\(^36\) and on a concern that the larger tax burden imposed on corporate investment distorts the allocation of capital among commercial ventures.

McLure has described the conduit view as central to the case for integration in the United States.\(^37\) However, as will be shown, there are reasons to adopt integration even if the conduit view is rejected. Indeed, as McLure also notes, many foreign countries which have rejected the conduit view nevertheless have adopted partial integration systems.\(^38\)

\(^{33}\) C. McLure, supra note 20, at 20.

\(^{34}\) Individual savings are combined (pooled) in order to enhance the size of the capital projects in which the investors (shareholders) can participate.

\(^{35}\) A partnership also represents a pooling of savings and services. The federal income tax system does not impose a tax on a partnership entity. I.R.C. § 701 (1987). Instead, partnership income and other tax attributes are allocated among the partners and treated as if incurred directly by the partners. Id. §§ 701-704. A partnership files a federal income tax return, Form 1065, only for informational purposes.

\(^{36}\) Horizontal equity is achieved when persons having the same amount of income pay the same amount of income tax. Vertical equity is achieved when persons having disparate amounts of income pay a disparate amount of income tax with the amount of the difference in taxes bearing a relationship to the difference in their income levels. See M. Fox, Finance and Industrial Performance in a Dynamic Economy 371-72 (1987).

\(^{37}\) C. McLure, supra note 20, at 20.

\(^{38}\) Id. at 44-45.
The opponents of integration reject the conduit view. They contend that while the conduit view of a corporation accurately describes a closely-held corporation, it is unrealistic to apply that view to publicly—held corporations. Through its managers, the publicly-held corporation typically has directions and goals that are independent of and sometimes adverse to those of its shareholders. Even so, the shareholders' surrender of a substantial portion of their control over the management of their funds does not alter the fact that they are the beneficial owners of those funds and that a tax on corporate earnings is a tax on earnings from the shareholders' savings.

In any event, even the opponents to integration agree that the conduit view is accurate for closely-held corporations. Accordingly, there is no conceptual justification for failing to integrate the taxation of the earnings of closely-held corporations. Congress implicitly has recognized the propriety of treating the assets of a closely-held corporation as the aggregate of its shareholders' investments by permitting integration treatment for such corporations when they elect to become an "S" corporation. The significance to the question of the desirability of reinstating a General Utilities doctrine of adopting the conduit view for closely-held corporations will be explored later in this Article.

Another aspect of the conduit view, if adopted, is that an unintegrated corporate tax exacerbates the inequity and economic bias engendered by imposing an income tax on savings. An income tax on the earnings derived from savings can be viewed as a double tax because the tax imposed on the principal amount on which savings interest is earned by the taxpayer incorporates a tax on the future earnings that are subsequently derived from the investment of the present savings. The capital that is invested in a corporation represents savings that have previously been taxed. A tax on corporate earnings then is a double tax to the same extent that a tax on all earnings from savings is a double tax. However, because the corporate tax is unintegrated, there is a third tax level imposed on corporate earnings when they are distributed as dividends to the shareholders. Thus, in many cases, the unintegrated corporate income tax system constitutes a triple tax on savings. Regardless of the terminology employed, the tax bias against savings is exacerbated when the corporate form is adopted.

Part III of this Article will consider the extent to which the income tax law provides mitigation for the double or triple tax on corporate earnings. In that context, Part IV of this Article will examine whether General Utilities justifiably mitigated the effects of the otherwise unintegrated corporate tax.

The reference above to double or triple tax impositions is simply one way to emphasize that the effective tax rate that is imposed on earnings from corporate investments is greater than the tax rate that would be imposed if an individual were to invest in a noncorporate form. The objection to the unintegrated corporate tax, especially by those who hold a conduit view of corporations, is not that corporate income is taxed twice or more. Rather, the objection is that a person

40. Id.
41. See sources cited supra note 28.
42. See infra text accompanying notes 96-123.
43. See infra note 32 and accompanying text.
44. See infra text accompanying notes 72-95.
who invests in corporate form will bear a higher tax on the earnings derived from that investment than he would bear if he invested in a noncorporate form.

2. Distortion of Capital Investments

Even if the conduit view is rejected, the financial and economic consequences of having an unintegrated tax may be regarded as sufficiently undesirable to warrant the elimination, or at least the mitigation, of that tax burden. If, because of the unintegrated corporate tax, the return on investments in corporate form is less than the return on investments in noncorporate form, then capital will shift away from corporate ventures to those operated in noncorporate form. There are nontax reasons for conducting certain types of businesses in corporate form and, thus, despite the added tax burden, activities will be conducted in corporate form. The flight of capital from corporate businesses will result in a reduction of the goods produced by corporations, and the increase in capital invested in noncorporate businesses will result in an increase in the goods produced by those businesses. Consequently, the rate of return from corporate investments will increase and the return from noncorporate investments will decline. This increase and decline in the rates of return will continue until the rates of return for corporate and noncorporate enterprises are in equilibrium. When that occurs, there will be no bias with respect to the type of investment to make because the return will be the same for both types. This equilibrium will create an overproduction of goods in the noncorporate sector and an underproduction in the corporate sector. In that event, consumers will overpay for corporate goods and underpay for noncorporate goods. If the imposition of an integrated corporate tax causes a substitution of the production of goods between industries, there will be a net welfare loss.45

If the above statement of the effect of the corporate tax on capital allocation is correct, that alone is a ground for considering the adoption of an integrated system. It is far from clear, however, that the tax has that consequence. Some economists contend that the corporate tax has no relevance to the allocation of capital investments.46 Harberger, one of the leading advocates of the theory that the corporate tax affects the rate of return on all capital, has suggested that when capital is free to move to foreign investments, and when a separate corporate tax burden is not imposed by foreign countries, the shift to a noncorporate form will not take place because the capital will go abroad. In that situation, the burden of the corporate tax may not be placed upon capital but rather may be borne by labor in the form of depressed wages.47 In that regard, it is noteworthy that, as previously discussed, most industrial countries other than

45. See Harberger, supra note 20, at 164-65. The theory that the burden caused by the corporate tax is borne by all capital investments is sometimes referred to as the “Harberger shift.”


47. Harberger, supra note 20, at 166. Joseph A. Pechman agrees with Harberger’s analysis that the corporate tax is borne by capital unless it can flee to foreign countries that do not impose a similar tax burden, in which case employees and other citizens will bear the burden of the corporate tax. Pechman, however, rejects integration as a solution. Pechman, supra note 24, at 177.
the United States do provide partial integration of the corporate and individual income tax.48

Whether or not the corporate tax burden alone causes a distortion of capital investment, the operation of the tax induces corporations to rely more on debt than they otherwise would and may provide an incentive for corporations to retain their earnings rather than to distribute them.49 The advantages of debt over equity in the current corporate tax structure is obvious. Interest payable by a corporation on its debt is deductible50 and is not subject to double taxation. The corporation's repayment of a debt typically will be a return of the creditor's capital and will not cause the creditor to recognize income as a consequence of receiving that repayment. On the other hand, a redemption of corporate stock may cause the shareholder to recognize ordinary dividend income.51

If a corporation is led to an excessively large debt-capital ratio, there are several negative consequences. The burden of a large fixed interest obligation can adversely affect corporate expansion or even the corporation's survival. The corporation will be poorly positioned to survive a temporary downturn in its business. The potential for bankruptcy makes a large debt structure especially undesirable. If a general downturn occurs in the economy, the proliferation of highly leveraged corporations may lead to the bankruptcy of a large number of businesses which, in turn, would cause a loss of confidence by investors, and a corresponding reduction in the amount of capital that will be invested in corporate form.52

Under certain circumstances, the current tax system creates a bias in favor of retention of corporate earnings rather than distributing them as dividends. The nature of this bias and the condition under which it exists are worth examining.

The unintegrated tax on corporate earnings creates a burden on investment in corporate form that is not imposed on noncorporate investments.53 But, once funds have been committed to a corporate enterprise, is the corporation's decision to retain or to distribute its earnings influenced by the imposition of a corporate tax? The answer to that question is not as straightforward as a casual glance might suggest. For example, suppose a corporation and a shareholder can earn the same rate of return on their investments—the rate to be determined on a before-tax basis—and the marginal tax rate of the corporation is equal to the marginal rate of the shareholder. If we assume that corporate earnings will ultimately be distributed to the shareholder as a dividend, the after-tax dollar amount that the shareholder will receive is exactly the same if the corporation retains its

48. See supra text accompanying note 21.
49. M. Fox, supra note 36, at 368-70.
50. In general, interest paid or accrued by a corporate debtor is deductible under § 163(a) of the Code. I.R.C. § 163(a) (1987). The limitations on the deductibility of investment interest and personal interest do not apply to corporate debtors. Id. §§ 163(d), (h).
51. Id. §§ 301(c), 302(d).
52. M. Fox, supra note 36, at 393-94.
53. See supra text accompanying notes 43-45.
earnings, invests them, and later distributes the net income (after taxes) from such investments to the shareholder.

Consider the following example. $G$, an individual, owns all of the outstanding stock of the $X$ corporation. $X$ has an ample amount of earnings and profits. $G$ and $X$ are in the same marginal tax bracket. They both are taxed on income at the marginal rate of thirty percent.\(^{54}\) $X$ earns a before-tax profit equal to ten percent of its investment. Similarly, on $G$'s noncorporate investments, $G$ earns a before-tax profit of ten percent of his investment. All of the income that is earned by $G$ and $X$ is ordinary income. In year one, $X$ has after-tax income of $100. $X$ can either invest that $100 at a ten percent return and later pay a dividend to $G$ of the $100 retained earnings plus the after-tax income earned from investing that $100, or $X$ can promptly distribute the $100 to $G$ who can then invest the net after tax income at a ten percent rate of return. In either event, as shown below, the amount that $G$ obtains after taxes will be the same.

First, consider the consequence of having $X$ distribute the $100 to $G$ in year one as a dividend. $G$ will pay a tax of $30 on that dividend and will then have $70 to invest. Because $G$'s investments earn a ten percent return, $G$ will earn $7 of income after a one year period. $G$ will pay a tax of $2.10 (30\% \times $7) on that income and after taxes $G$ will retain $4.90 of his income from the investment. After one year, $G$ will have a total of $74.90 from the distribution of $X$'s earnings plus the net income from investing that amount.

On the other hand, consider what occurs if $X$ retains the $100 of earnings and invests them at ten percent. After one year, $X$ will earn income of $10 on its investment, and $X$ will pay a tax of $3 on that income. Thus, $X$ will retain $7 after taxes from its investment. If $X$ promptly distributes a $7 dividend to $G$, he will pay a tax of $2.10. Thus, $G$ will retain the sum of $4.90 after taxes from the income from the investment of the corporation's $100 of retained earnings. Note that this amount is identical to the amount that $G$ would have retained if the $100 had been distributed to $G$ in year one and the net proceeds then invested directly by $G$ himself. Of course, if, at the end of the one year period $X$ distributed to $G$, as a dividend, the original $100 of retained earnings, $G$ would retain $70 of that amount after payment of taxes. The total amount retained by $G$ would then be $74.90, the identical amount that $G$ would have retained if he had received a current distribution of the $100 in Year One and had then invested the net proceeds.

If the marginal tax bracket of the shareholder is lower than that of the corporation and if the other assumptions made above are applicable, the amount retained by the shareholder will be greater if the corporation currently distributes its earnings rather than retains and invests them. In the context of some small corporations with taxable income of less than $75,000, it is possible that the

\(^{54}\) Under current law, neither $G$ nor $X$ can be in the 30\% tax bracket. The maximum marginal rate on $X$'s taxable income is 34\%. I.R.C. § 11(b) (1987). The maximum marginal rate on $G$'s taxable income is either 28\% or 33\%. Id. § 1. The 30\% rate is used in the example in the text for ease of calculation. The same rate is used for both the individual and the corporation in order to illustrate the concept that tax consequences are neutral in that circumstance, given the assumptions listed in the text.
corporation's marginal rate will be less than that of its shareholders.\textsuperscript{55} If the corporation has taxable income in excess of $335,000, the corporation's tax rate will be a flat thirty-four percent rate. Such corporations always will be in a higher tax bracket than are their individual shareholders, who cannot be taxed at a rate in excess of thirty-three percent.\textsuperscript{56} It would seem, then, that for such corporations there is a tax bias inducing the corporations to distribute their earnings currently rather than to retain and invest them. Several reasons suggest the opposite may be true; that there are tax incentives for the corporation to retain its earnings.

First, the corporation, through its accumulation of a large amount of capital, can make investments that produce a rate of return that may not be available to the individual shareholder if he invests separately in his own right. Therefore, the assumption that the corporation and the shareholder can earn the same rate of return will be unrealistic in many cases. A shareholder can invest in a partnership form and, thereby, obtain the advantage of a larger pool of capital without having to incur double taxation, but the availability of such investments is limited in that there are certain types of activities that cannot readily be conducted in a noncorporate form.\textsuperscript{57} Of course, if the shareholder has to invest in another domestic corporation to obtain the same return on investment, the second corporation's income will be subjected to double taxation, and the shareholder will net much less than he would receive if the first corporation retained and invested its earnings. For example, if \( G \), in the example above, were to invest the $70 of after-tax dividend that he obtained in year one in a second corporation, \( Y \), and if \( Y \) earned a return of ten percent on its investments,

\textsuperscript{55} Except for personal service corporations, a corporation with taxable income of less than $100,000 pays taxes at a rate of 15% on its first $50,000 of taxable income, and it pays taxes at a rate of 25% on its next $25,000 of taxable income. \textit{Id.} § 11(b). An individual's tax rates are graduated as follows: 15%, then 28%, then 33%, and then back down to 28%. \textit{Id.} § 1. It is possible, therefore, that an individual shareholder could be in a higher tax bracket than is the corporation.

\textsuperscript{56} The tax rate figures used in the text are based on the rate schedules adopted by \textit{TRA 1986} and effective for the taxable year 1988. It is noteworthy that \textit{TRA 1986} substantially expanded the scope of the alternative minimum tax (AMT) for corporations and thereby increased the tax liability borne by many corporate enterprises. \textit{Id.} §§ 55-57. While the scope of the AMT for individuals also was expanded, the impact of the 1986 revisions will fall primarily on corporations. \textit{See Freeman, Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities, 64 T\textsc{axes} 962, 963 (1986).} This is largely due to the inclusion for AMT purposes of a positive adjustment to taxable income for a fraction of the difference between a corporation's book income or its earnings and profits and a modified version of its taxable income. \textit{I.R.C.} §§ 56(f), (g) (1987). Because of the AMT, more individuals will pay a lesser tax on business income that they earn in a noncorporate form than the tax that would be payable by a corporation if the business is incorporated, and the spread between the tax borne by individuals and corporations will expand.

\textsuperscript{57} For example, the limited liability provided to shareholders can be of great importance to investors in a business that has a risk of a large amount of loss. So, corporate form may be imperative for a business with potential liability for large tort claims or for a volatile business. Also, if investors wish to have different types of interests in a business, including tiered ownership, that can be accomplished easier in corporate form than in partnership form. Another consideration for publicly—held enterprises is that corporate stocks are easier to market than are partnership interests.


Y would earn $7 of income, pay a tax of $2.10, and then have only $4.90 to distribute to G as a dividend. G would pay a tax of $1.47 on that $4.90 dividend, and G would retain only $3.43 after taxes. This amount compares unfavorably with the $4.90 that G would obtain if X retained the $100 of its net earnings and distributed the net income therefrom to G.

A second consideration is that in order to get a corporation's retained earnings into the hands of a shareholder, it might not be necessary to distribute them as a dividend. If the earnings and income therefrom are retained, they can be distributed to G, to his estate, or to his heirs at some future date as a stock redemption or as a liquidating distribution. Because of the elimination of preferential tax treatment of capital gains, it would make little difference whether the distribution to G is a dividend or a liquidating distribution. However, if G holds his stock until his death, a subsequent liquidating distribution may not cause G's estate or heirs to incur any income tax liability because of the step-up in basis at death provided by section 1014.

A minor consideration is that if a corporation retains its earnings and invests them in the stock of a domestic corporation, only thirty percent of the dividend income it receives on that stock will be subject to tax. Thus, the effective corporate tax rate on the dividend income received from a domestic corporation will be only thirty percent of the rate that otherwise would be applicable. A corporation in a thirty-four percent marginal tax bracket will, therefore, pay tax at a rate of only 10.2% on the dividend income it receives from a domestic corporation.

In the American Law Institute's (ALI) publication of its Federal Income Tax Project on the Study of Subchapter C, the ALI published a study of its reporter, Professor Andrews, that addressed the tax treatment of retained earnings. Professor Andrews noted that an unintegrated tax system creates a bias in favor of a corporation borrowing needed capital rather than obtaining it as an investment in the corporation. To neutralize that bias, Professor Andrews recommended that dividends paid from earnings derived from invested capital be deductible by the corporation. This proposed dividend relief is a form of partial integration.

Professor Andrews also recognized that the current tax system favors the retention of corporate earnings in corporate solution. He states that the deferral of a shareholder’s tax on his share of corporate earnings is comparable to allowing the shareholder a deduction for making a capital contribution to a corporation. Because that bias already exists, Professor Andrews recommended.

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58. See TRA 1986, supra note 6, § 301, at 2216.
60. Id. § 243(a)(1).
62. Id. at 327.
63. Id.
64. Id. at 328.
65. Id. at 330. Professor Andrews does not claim that the deferral of a shareholder’s tax on retained earnings is identical to granting a deduction for investing in a corporation, but he does believe that the results are similar. Professor Andrews notes that the current tax system favors distributing corporate earnings if the shareholder is in a lower tax bracket than the corporation. Id. at 359. As noted in the text, because of the changes made in 1986 to the tax rate schedules, in many circumstances individual shareholders will be in a lower tax bracket than the corporation. However, other considerations may counteract what appears to be a bias in favor of corporate distribution of earnings where the shareholder is in a lower tax bracket than the corporation.
that no deduction, that is, no partial integration, be provided for dividends paid out of income derived from retained earnings as contrasted to income derived from newly contributed equity capital. Professor Andrews made those recommendations several years prior to the adoption of TRA 1986. As noted above, in light of the changes that were made in the tax rate schedules, it is unclear the extent to which there continues to be a tax bias in favor of retention of corporate earnings.

A question arises whether it is undesirable to have tax laws structured to encourage the retention of corporate earnings. Some commentators believe that the retention of corporate earnings promotes inefficiency and a disinclination to engage in innovative projects. If a corporation's earnings were distributed to its shareholders, the corporation would have to compete with the shareholder's other investment opportunities for the reinvestment of those earnings. This competition should result in the placement of the earnings where they will be most productive. On the other hand, if the corporation can retain its earnings, it can use them to finance projects that may be less productive than others available in the market. One problem with this view is that the transactional costs of the distribution and reinvestment of the earnings and the imperfection of an investor's available information have to be taken into account. Another consideration in favor of the retention of corporate earnings is that the propensity of the American public for consumption suggests that a portion of dividend payments will be used for consumption rather than for reinvestment.

Regardless of whether it is more or less desirable for corporations to retain their earnings to finance new ventures or the expansion of old ventures, there is reason to avoid allowing the retention or distribution decision to be influenced by the tax laws. If a legislative decision were made that it is in the best interests of the economy and of society to encourage corporations either to retain or to disgorge their earnings, then a deliberate legislative choice might utilize the tax law to provide a benefit for taking the desired action or to impose an added burden on the undesired action. But, in the absence of a deliberate legislative decision to influence corporate action, the tax laws should be designed to be as neutral as is feasible given other considerations. In other words, an unintended nudge in one direction is more likely than not to be harmful.

There are three possible solutions to the question of the proper legislative response to the issue of the desirability of a corporation's distributing its earnings currently. One possibility is that there is no universal preference and that the decision should be left to the corporation and to market influences on management's ad hoc decision. A second possibility is that market influences are not adequate to offset the bias of management to retain earnings and that legislative pressure should be exerted to induce management to distribute its earnings currently. A third possibility is that it is more desirable to have corporations retain and reinvest their earnings and that legislative pressure should be exerted to offset the shareholders' desire for current distributions. Because there are three possible solutions, albeit of different degrees of likelihood, a legislative act that

66. Id. at 330-31, 358-400.
67. See supra notes 53-60 and accompanying text.
unintentionally skews the corporation's decision in one direction is more likely to be wrong because it adversely impacts on two of the three possible solutions.

Employing a "pass-through" system to integrate the corporate and individual income taxes would eliminate any bias that currently exists in favor of the retention of corporate earnings. Alternatively, the bias could be eliminated by making other tax changes that offset the benefit currently provided for retained earnings in certain circumstances, but those changes are likely to create new biases that influence a different set of corporate or financial decisions. One of the side effects of adopting a tax provision to neutralize the impact of taxes on the choice between alternative courses of action is that the new provision will create a tax preference for or against certain other choices. For the purposes of this Article, it is sufficient to note that one of the consequences of having an unintegrated tax is that in some circumstances it creates a tax bias in favor of retention of corporate earnings.

In sum, if a conduit view of a corporation is adopted, an unintegrated tax is inequitable in that it taxes the earnings from investments that are made in corporate solution at a higher rate than those imposed on earnings from noncorporate investments. The significance of equity considerations is weakened somewhat because of the uncertainty of the extent to which the corporate tax burden is borne by shareholders. Regardless of whether a conduit view is adopted, the unintegrated tax has the following undesirable consequences: (1) Distorting the allocation of capital among different types of investments which, in turn, results in the overproduction of some types of goods and the underproduction of others so that there is an overall welfare loss; (2) encouraging excessive leveraging of corporations, which has numerous adverse financial consequences, including an increase in the number of bankruptcies that occur when there is a downturn in the economy; and (3) influencing the decision whether to retain corporate earnings and commit them to corporate ventures or to distribute them to the shareholders.

69. For example, in the absence of special provisions, the tax law creates a bias in favor of performing services for one's self or one's family rather than to pay another to perform that task (in which event, the taxpayer then can use the released time to produce additional income or for leisure). This bias exists because gross income does not include services performed for one's self or one's family, but the payments to another to perform those services are not deductible expenses. For example, when parents have a young child, it is often necessary to choose between having one spouse stay at home and care for the child, or having both spouses employed on a full time basis with the child cared for by some type of child care arrangement. The fact that a spouse's services of caring for the child will not be included in the spouses' gross income and that the payment for child care services will not be deductible creates a tax bias in favor of having one of the spouses stay home and care for the child. For social policy and political reasons, Congress chose to minimize that tax bias so that the decision whether to seek employment or to remain home can be made without as much regard to tax consequences. Currently, that minimization of tax consequences is accomplished by providing a tax credit for a portion of the child care (or other dependent care) expenses incurred to permit the taxpayer to be gainfully employed. I.R.C. § 21(b)(2)(C) (1986). While that tax credit neutralizes much of the tax influence on the decision to work or to care for one's child, it also reduces the cost of rearing a child and thereby creates a tax bias in favor of having children. That is not to say that people who would not otherwise want children will decide to have them because of the tax credit. Rather, it is to say that people who want children, but who are deterred by the financial cost of bearing nondeductible and noncreditable expenses, or by having one spouse cease to be employed, will find the cost more economically feasible because of the credit. For some families that difference will be just enough to tip the balance in favor of having a child.
C. An Explanation of Congress' Failure to Integrate Corporate and Individual Taxes

If integration is as beneficial as described above, why has Congress retained an unintegrated tax system? Indeed, why has Congress deleted from the Code most of those provisions that provided some relief from the double tax system and thereby accentuated the impact of the unintegrated corporate tax? One can only speculate regarding the reasons for Congress' behavior.

One possible explanation is that a majority of Congress rejects the conduit view of a corporation and, accordingly, rejects much of the ground on which the case for integration lies. Even if that is so for large corporations, it does not explain why small, closely-held corporations are subjected to a double tax unless they qualify for and elect Subchapter S treatment. There are a number of outstanding tax commentators who embrace the unintegrated tax approach on various grounds. The Congressional adoption of that approach cannot be described as wholly unjustified.

A more cynical explanation exists for the policy decision to retain an unintegrated tax. It is quite likely that most members of Congress have no view whatsoever with respect to whether, for tax purposes, a corporation should be viewed as an aggregate of investments by its shareholders or as a separate entity. They may care very little about the inequity of taxing income derived in corporate form at a higher rate than income earned directly or in partnership form. Instead, Congress may simply view the unintegrated corporate tax as a useful means of raising revenue without stirring a rebellion among those who bear the burden of the tax.

One major political advantage of an unintegrated corporate tax is that the incidence of the tax is hidden. It appears to be a tax on an inanimate entity and, therefore, can relieve some of the tax burden that is carried by natural persons. Those persons who actually bear the incidence of the corporate tax are generally unaware of it. Even economists are uncertain where the final burden will rest.

Of course, the ultimate consequence of taxing corporate income will fall on natural persons. In the short run, those persons are almost certain to be the shareholders. In the long run, however, some of the incidence of the corporate tax may fall on the employees of the corporation and on the consumers who purchase the goods or services of the corporation. It is easier to "sell" the tax to the public if they believe that the tax is borne by others. Indeed, many members of the public rejoice at the taxing of corporations that are viewed as excessively wealthy institutions that have prospered by failing to pay their fair share of the costs of maintaining a government. If the tax were seen as a tax on wages or as a sales tax on consumers, it would lose much of its appeal.

70. See, e.g., Surrey, supra note 24; Pechman, supra note 24.
71. One tax mission described the corporate tax as "politically popular, easy to administer, and productive of substantial revenues." U.S. TAX MISSION TO JAPAN (Shoup Mission), 1 REPORT ON JAPANESE TAXATION 105 (quoted in M. NORR, supra note 68, at 30, where Norr added: "There are fewer corporations and shareholders than individual citizens, and shareholders may be less inclined to resist corporate taxes or tax increases than to resist individual taxes or tax increases").
General Utilities Reinstated

One reason offered in support of the unintegrated corporate tax is that it increases the progressivity of the tax system. Because those with relatively small amounts of income do not have disposable dollars to invest, most shareholders are commonly in the middle or high income tax brackets. Assuming that most of the incidence of the corporate tax falls on shareholders, the corporate tax is a means of increasing the effective tax rate of higher income taxpayers. The interest in increasing progressivity may be especially strong in light of the essentially flat-rate tax system that went into effect in 1988 for individual taxpayers. On the other hand, the enhancement of a more progressive tax structure appears to be inconsistent with the apparent goal of TRA 1986 to move towards a relatively flat-rate system.

The progressivity rationale appears to be somewhat strained. It would be preferable to deal with the progressivity question directly in the tax rate schedules for individuals. This is especially true since the corporate tax system causes a distortion in the types of goods produced, which gives rise to an overall welfare loss. Also, to the extent that the incidence of the tax falls on labor and consumers, rather than on the shareholders, the tax will not provide progressivity.

III. Mitigation of the Unintegrated Tax System

The tax law always has provided some mitigation or escape valve from the imposition of double taxation on corporate income. Some of those relief provisions—such as the small exclusion that was provided to noncorporate shareholders for dividends received from domestic corporations—were eliminated by TRA 1986.72 Others still survive, but there is much less relief under current law than previously existed.

A corporation may escape the double tax burden by employing its shareholders and paying them a salary for their services. A reasonable salary typically will be deductible by the corporate employer under Section 162 as a business expense,73 unless the services were provided in connection with the creation of a capital asset.74 In Charles McCandless Tile Service v. United States,75 the Commissioner successfully contended that a profitable corporation could not avoid dividend characterization of amounts paid to its shareholder-employees by designating all such payments as salary, even if the salary was reasonable in amount.76 The court recharacterized as dividends a portion of the amounts paid to the shareholder-employees. Consequently, that amount was not deductible by the corporation. This approach became known as the “automatic dividend” rule. Subsequent court decisions rejected the automatic dividend rule, and the Commissioner eventually conceded that the rule announced by the court in

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72. Section 612 of TRA 1986 repealed the dividend exclusion for individuals. TRA 1986, supra note 6, § 612, at 2250. Prior to that repeal, the first $100 of qualified dividends received by an individual shareholder ($200 for a married couple filing jointly) were excluded from income by § 116 of the Code.
75. 422 F.2d 1336 (Ct. Cl. 1970).
76. Id. at 1339-40.
The payment of salaries to shareholder-employees, therefore, remains a viable method of avoiding double tax consequences for small, closely-held corporations. Because of their size, publicly-held corporations cannot employ most of their shareholders.

Another means of avoiding double taxation is to have shareholders refrain from contributing needed properties to the corporation and, instead, have them lease the property to the corporation. The rental expense may be deductible by the corporation under section 162 as a business expense.78 Again, this device will be useful only to small, closely-held corporations.

A widely adopted means of reducing the sting of double taxation is to obtain much of the corporation’s needed capital by incurring a proportionately larger amount of debt rather than seeking equity contributions. There are serious negative consequences to having a corporation incur a high debt-capital ratio,79 but the importance of minimizing the impact of double taxation is so great that many businesses are willing to accept the risks and burdens of being heavily leveraged. Leveraging is used by both large and small corporations.

The General Utilities doctrine provided another measure of relief for the failure to integrate fully. When a corporation distributed an appreciated asset to a shareholder, only a single tax was imposed unless one of the exceptions to General Utilities was applicable. While, with respect to nonliquidating distributions, the General Utilities doctrine was eroded over the years, it remained substantially intact with respect to liquidating distributions until the doctrine was repudiated by the adoption of TRA 1986.80

A related provision to the General Utilities doctrine was the pre-1986 version of section 337 that granted nonrecognition to a liquidating corporation for certain sales of its assets pursuant to the liquidation. This provision was subject to certain exceptions and was available only if there was compliance with several conditions. This provision was repealed by TRA 1986.

There appears to have been several considerations that led Congress to repudiate the General Utilities doctrine and allied provisions. These considerations are discussed in Part IV of this Article.81

For closely-held corporations that qualify for Subchapter S treatment, an election to be an “S” corporation is a means of avoiding double taxation. In general, an “S” corporation pays no federal income taxes, and its tax attributes are passed on to its shareholders.82 However, if a “C” corporation83 elects to

77. Edwin’s, Inc. v. United States, 501 F.2d 675, 677-78 (7th Cir. 1974); Laure v. Commissioner, 70 T.C. 1087, 1098 (1978); see also Rev. Rul. 79-8, 1979-1 C.B. 92-93. A purported salary payment can be recharacterized as a disguised dividend if there is evidence that the payment was not made for services, or to the extent that the amount of the payment is unreasonably large. However, the automatic dividend rule is dead.


79. See supra text accompanying note 52.

80. See supra text accompanying notes 6-9.

81. See infra text accompanying notes 155-57.

82. I.R.C. §§ 1363(a), 1366 (1987). One exception to the general rule of immunity from income taxation is that an “S” corporation is liable for the tax imposed as a recapture of an investment credit that is applied on the premature disposition of an asset for which an investment credit previously was taken in a year in which the corporation was not an “S” corporation. Id. § 1371(d)(2). As a consequence of the repeal of the investment credit by the TRA 1986, this exception is of diminishing significance and soon will become dead wood.

83. A “C” corporation is any corporation that is not an “S” corporation. An entity becomes an “S” corporation by virtue of a valid election to have Subchapter S apply to it. Id. § 1361(a)(2).
become an "S" corporation, in certain circumstances specified types of income of the resulting "S" corporation still will be taxed to the corporation. Therefore, even under "S" corporation status, the income may be taxed twice—once to the "S" corporation itself and once to the shareholders.  

Not all corporations can qualify for Subchapter S treatment. There are a number of requirements. To qualify under section 1361, a corporation: (1) Must be a domestic corporation that is not a member of an affiliated group; (2) must have no more than thirty-five shareholders none of whom is a nonresident alien and none of whom is any person other than an individual, the estate of an individual, or certain (but not all) types of trusts, and; (3) must have only one class of stock outstanding. There are additional requirements, and there are a number of circumstances in which a Subchapter S election can be terminated inadvertently.

Prior to 1986, the benefits of corporate tax treatment and the relief from double taxation were of such magnitude that, for many business operations, there was a tax bias in favor of operating in corporate form. For example, because of perceived tax advantages of the corporate form, in the 1960s, the professional service corporation became a popular mode of operation for lawyers and doctors. One advantage of the corporate form was that there was greater flexibility and availability of deferred compensation for employee-shareholders than was available for self employed persons such as partners and sole proprietors. That is no longer true. Also, the corporation typically was taxed at a lower rate than was imposed on individuals. The difference between the amount of tax payable by the corporation and that which would have been payable by the shareholders if the income were earned by them in their capacity as individuals constituted a deferral. The price of that deferral was a higher overall tax on distributed corporate income, but in many cases the value of the deferral exceeded the additional tax cost imposed by the double tax. The burden of the double tax often could be lightened by arranging the distributions to the shareholders so that they were taxed at preferential capital gains rates. If the

84. Section 1374 imposes a tax on an "S" corporation for the recognition of "built-in gains." In essence, a "built-in gain" is a recognized gain of an "S" corporation on the disposition of an asset to the extent that the gain is attributable to the amount of appreciation of that asset at the time that the corporation converted from "C" corporation status to an "S" corporation. This provision applies primarily to gains recognized during the ten-year period following the conversion of a "C" corporation to an "S" corporation. Id. §§ 1374(a), (c)(1), (d)(3). In certain circumstances, § 1375 imposes a tax on an "S" corporation's "passive investment income," but this tax applies only if the corporation had previously been a "C" corporation and still has earnings and profits that were earned when it was a "C" corporation. Id. § 1375.

85. Id. § 1361.

86. Id. § 1362(d).


88. See McCluskey, supra note 87, at 148.

89. For example, as late as 1981, the maximum tax rate applied to an individual taxpayer was 70%, and the maximum tax rate applicable to a corporate taxpayer was 46%. I.R.C. §§ 1, 11 (1981). Contrast that with the rates that are applicable to 1988, where the maximum rate applied to an individual taxpayer is 28% (or possibly 33%) and the maximum rate applicable to a corporate taxpayer is 34%. I.R.C. §§ 1, 11 (1987).
distribution was delayed until after the shareholder’s death and was then made as a payment for a stock redemption or as a liquidating distribution, there might be no additional tax on the receipt of that distribution. The lighter the double tax burden, the greater was the net benefit of having a deferral of tax liability because of the lower rates paid by corporate taxpayers.

As a consequence of changes adopted as part of TRA 1986, there will be fewer, if any, circumstances when there will be a tax advantage to operating a business as a “C” corporation. To the contrary, the tax burdens imposed on doing business as a “C” corporation are of such magnitude that there is a strong incentive to avoid that business form where nontax circumstances permit. In general, it is not feasible for a large, publicly-held business to operate in any form other than that of a “C” corporation. However, closely-held businesses frequently have a choice, and there is reason to believe that tax considerations will cause such businesses to be conducted as partnerships or, where available, as “S” corporations. Indeed, many existing small corporations will convert to partnership or Subchapter S status because of TRA 1986 changes. The rigid requirements of Subchapter S status will prevent many businesses from making that election and thus there will be a substantial increase in the number of businesses conducted in partnership form. Of course, the number of “S” corporations also will rise. For a number of businesses, nontax considerations will induce them to incorporate and, in many cases, Subchapter S will not be available so that those business enterprises will have to accept double taxation.

The principal tax changes that have made “C” corporation status undesirable for small corporations are: (1) The changes made to the tax rate schedules; (2) the elimination of preferential treatment for net capital gains; and (3) the elimination of the General Utilities doctrine. For example, if the marginal tax rate on X corporation’s income is thirty-four percent and the marginal tax rate on B, the sole shareholder of X, is twenty-eight percent, a gain recognized by X on the sale of an asset, the net proceeds of which (after taxes) are distributed to B, will bear a tax at a rate of slightly less than 52.5 percent. For convenience, in this Article, the total rate payable in order to have the corporation’s gains

90. Under § 1014, the basis that a shareholder’s estate or beneficiary has in the shares of stock that the shareholder held is equal to the fair market value of those shares at the shareholder’s death (or, in certain circumstances, the fair market value at a date within six months after the shareholder’s death). In a liquidating distribution, or in a stock redemption that is treated as a purchase, the gain recognized by the shareholder-distributee is the excess of the amount distributed over the basis that the distributee has in the redeemed or canceled stock. Id. §§ 302(a), 331(a). Unless the value of the stock has increased significantly between the date of the shareholder’s death and the date on which the redemption or liquidation takes place, there will be little or no gain recognized by the distributee. In this regard, note that a redemption of stock that was included in a decedent’s gross estate for federal estate tax purposes may qualify for purchase treatment under § 303 regardless of whether the redemption otherwise would have been treated as a dividend under § 302(d).

91. See Freeman, supra note 56, at 962-67.
92. Id.
93. Id.
94. The corporation will pay a tax of 34% and will then distribute the remaining 66% to its shareholder, B. B will pay a tax of 28% on 66% of the proceeds of X’s gain that he receives as a distribution, and that tax equals 18.48% of the gain recognized on X’s disposition of the asset. The sum of 34% and 18.48% is 52.48%.
placed in the hands of a shareholder will hereafter be rounded off to fifty-two percent. The fifty-two percent rate payable on business income earned by a "C" corporation is in sharp contrast to the twenty-eight percent rate that would be payable if the business is conducted in partnership or sole proprietorship form or as an "S" corporation. In the past, the twenty-four percentage points differential in rates might have been mitigated by the operation of the General Utilities doctrine and by preferential capital gains rates on liquidating distributions. These relief measures are no longer available.

To the extent that it is feasible to do so, the tax laws should be designed to have the least possible influence on the decision of the form in which to conduct a business. Different forms for the conduct of business have been provided by state laws in order to facilitate the investment of capital and the conduct of business operations. If the tax laws inadvertently operate to skew those decisions, they will interfere with state policies and may prove injurious to the economy. It may well be that prior to 1986, especially for small, closely-held businesses, the tax laws were skewed in favor of choosing a corporate form in which to conduct the business, but that does not justify having the current tax laws discourage the use of the corporate form.

IV. THE ROLE OF THE General Utilities DOCTRINE

A. The Place for General Utilities in the Structure of Subchapter C

In order to determine whether the General Utilities doctrine should have a place in the post-1986 tax law, it is useful to reflect on the reasons for having an unintegrated corporate tax. Also, it is helpful to consider the extent to which those reasons dictate that the unrealized appreciation of a corporate asset that is distributed out of corporate solution should be taxed twice—once at the corporate level and once at the shareholder level.

Even those who adopt a conduit view of a corporation support the requirement that a corporation be required to pay a tax on its current income. If there were no corporate tax payment, the corporate entity could be used as a device to defer tax liability until the income was distributed out of corporate solution. A corporate tax payment is not needed if the "pass-through total integration system" were adopted, but the administrative costs engendered by that system are so burdensome that there is no realistic possibility of its adoption. Thus, for both those who adopt and those who reject the conduit view of a corporate entity, an important function of the corporate income tax is to prevent the deferral of tax liability until the earnings are distributed to shareholders. Canada's Royal Commission on Taxation (the Carter Commission) confessed in its study that it could find "no grounds in principle for taxing corporations," but the

95. M. NORR, supra note 68, at 55. Norr states that "[f]rom the standpoint of economic efficiency, then, the tax system should be as nearly neutral as possible in its impact on different forms of business organization." Id. Norr also states that tax discrimination against the corporate form has the greatest influence on small businesses because they have an option to choose other business forms. Id. at 56.

96. CANADIAN ROYAL COMMISSION ON TAXATION, 4 REPORT OF THE ROYAL COMMISSION ON TAXATION 4 (quoted in M. NORR, supra note 68, at 29).
Commission recommended the adoption of a corporate tax partly because the failure to provide a corporate tax "would permit massive and unwarranted postponement of personal income tax." Some of those who reject the conduit view prefer that the corporate tax not be integrated. However, as previously noted, one can be an integrationist without espousing the conduit view. The principal reason for having an unintegrated corporate tax, other than political expediency, is that it is a price imposed for the privilege of doing business in corporate form, which provides several advantages such as limited liability for the shareholders.

When a corporate asset is distributed to a shareholder, regardless of whether it is made as a liquidating or a nonliquidating distribution, the shareholder will have immediate tax consequences. When a distribution under section 301 is made to a shareholder in respect to stock holdings, the distribution will be considered ordinary income to the shareholder to the extent that it is made out of the corporation's earnings and profits. In the situation of liquidating distributions or distributions in redemption of stock that are treated as a purchase, the shareholder will recognize a gain to the extent that the amount distributed exceeds his basis in the redeemed stock.

When a distribution in kind is made to an individual shareholder, the income that is generated thereafter by the distributed asset will not be in corporate solution and will be taxed to the individual shareholder. There is no potential for deferral of income because of the intervention of a corporate entity and, therefore, the imposition of a corporate tax on the distributing corporation cannot be justified on that ground. Because the subsequent income stream from the distributed property is neither earned nor received by a corporation, there is no reason to exact a price for the privilege of earning that amount under the aegis of the corporate law provisions.

Because of the changes in tax rate schedules that were adopted in 1986, there is much less reason to fret over the possibility that a corporate entity can be used to defer the full impact of a tax that would have been imposed if the income were earned by an individual. The danger of deferral arises only if the corporate tax rate is lower than the rate applicable to the individual shareholders. For post-1987 years, a corporation often will have higher tax rates applicable to it than those that apply to its shareholders. However, for corporations with

97. *Id.* at 5.

98. *I.R.C.* § 316(a) (1987). If a dividend is paid to a corporate shareholder, the distributee may be entitled to a dividend received deduction for a percentage of the dividend. *Id.* § 243. However, in such cases, the distributed property remains in corporate solution, and the income generated by that property will be subject to the unintegrated corporate tax. Moreover, if a dividend of appreciated property is distributed in kind, the corporate distributee's basis in the distributed property will equal the basis that the distributing corporation had therein, plus any gain recognized by the distributing corporation as a consequence of paying the dividend. *Id.* § 301(d)(2). If General Utilities were reinstated so that the distributing corporation would recognize gain only in limited circumstances, there would be a carryover of basis to the distributee corporation.

99. *Id.* §§ 302(a), 331(a). The circumstances in which gain will not be recognized by a shareholder because his basis in his redeemed stock is no less than the amount distributed to him are discussed later in this Article. See infra text accompanying notes 104-06. Also, the circumstances in which a shareholder incurs no federal tax liability on receiving a distribution because the shareholder is a tax-exempt entity, or is a foreign person, are discussed later in this article. See infra text accompanying note 105.
an annual taxable income of less than $100,000, the tax rate schedules might favor the corporate entity so that deferral of tax is a possibility. Even in that circumstance, once the asset is in the hands of a noncorporate shareholder, the future income stream will be taxed to the shareholder, and will not be protected by lower tax rates of the corporate entity.

If a liquidating distribution is made in kind to a corporate shareholder, the subsequent income stream from the distributed property will continue to be received in corporate solution. However, unless the distributing corporation is a controlled subsidiary of the distributee, it will be taxed under section 336(a) on the amount of appreciation of the distributed asset. In addition, the distributee corporation will recognize a gain—or a predecessor shareholder previously will have recognized a gain—on its receipt of the distribution. Finally, when the asset or its proceeds ultimately are distributed to individual shareholders of the distributee, the individuals—or predecessor shareholders—will incur a personal income tax liability because of that appreciation. Thus, there will be a triple tax incidence in such cases. If General Utilities were to apply to prevent the distributing corporation’s recognition of gain, the gain would be subjected to double taxation—one to the distributee corporation and once to individual shareholders of the distributee—rather than to the triple tax that is imposed under existing law.

The price at which an asset is purchased or sold reflects the present value of the income that the asset will produce over future years. The market price represents the market’s estimate of the future income stream of the asset and the rate of discount to be used for the risk that the market believes that the use of the asset presents. In other words, the purchase price of an asset is a capitalization of the future earnings that it is estimated the asset will produce.

The income stream that is produced by an investment can be divided into two subparts. The first subpart is a partial recovery of the amount invested. For example, if a taxpayer invests $100 in the acquisition of an asset that produces an annual income of $10, a part of the $10 income that the taxpayer receives in a given year constitutes a recovery of that portion of the taxpayer’s $100 investment that was paid for the right to receive the annual payment for that year. Obviously, that portion of the income stream should not be taxed. One means of exempting that portion would be to provide the taxpayer with a depreciation deduction for a portion of the asset’s basis. The depreciation deduction offsets that amount of the income stream. For convenience, this Article refers to that portion of an asset’s income stream that represents the recovery of the taxpayer’s cost as the “cost recovery income.” Because the actual depreciation deduction that is permitted a taxpayer under the Code for a taxable year does not necessarily equal the “cost recovery income” for that year, the

100. See supra notes 55-56 and accompanying text. This circumstance likely will occur only with regard to closely-held corporations with relatively small amounts of taxable income. To some extent, a small corporation can suppress its taxable income by making deductible payments to its shareholders for their services or for the leasing of business assets. This technique can keep the corporation in a lower tax bracket so that deferral of tax liability becomes a possibility. There are limits on the amount of deductions that can be generated in this fashion, so not every closely-held corporation will be able to reduce its taxable income to a sufficiently low level to obtain that benefit.
depreciation deduction and the "cost recovery income" for a year typically do not match. The explanation for the disparity lies in the tax policy behind the determination of depreciation deductions.\footnote{101} For convenience, in the subsequent discussion in this Article of income stream, the depreciation allowance will be deemed to equal the cost recovery income.

The portion of the income stream that does not qualify as "cost recovery income" constitutes the second subpart of an asset's income stream. The cost of the right to an asset's future income stream is determined by discounting the total future income to its present value. When a year's income from such an asset is received, the amount received will be greater than that year's predetermined income value had been when the asset was purchased by the taxpayer. In other words, the amount paid by the taxpayer for a year's income, and consequently the depreciation allowance for that year, will be less than the actual income received in that year. The difference between the income received in a year and the depreciation allowance for that year will be taxed. The portion of a year's income from an investment, designated herein as "second subpart income," represents the discount used in determining the amount to be paid for that year's income plus or minus any increase or decrease in the income stream due to unrealized appreciation or depreciation of the asset that occurred after the asset was acquired by the taxpayer. For convenience, this Article will refer to the second subpart of an asset's income stream as the "discount income."

When an investment is made in a nonwasting asset, no depreciation deduction will be allowed to the taxpayer. The reason that no deduction is allowed rests on the notion that the depreciation allowance for an asset should represent a decline in the value of that asset.\footnote{102} Consequently, all of the income stream produced by a nonwasting asset will be taxed. The entire income stream from an investment in a nonwasting asset, therefore, can be described as "discount income"—assuming that the zero allowance of a depreciation deduction properly reflects a zero "cost recovery income" amount.

When a taxpayer recognizes a gain on the disposition of an asset and then reinvests the proceeds from that disposition, the reinvestment will produce an income stream that can be divided into two parts. Part of the income stream is the product of investing that portion of the sale proceeds that represented the taxpayer's basis in the asset. The remaining part of the income stream, the "appreciation income," is the product of the reinvestment of that portion of the sale proceeds that represent the gain that the taxpayer realized on the disposition of the asset. The "appreciation income" produced by the reinvestment of the proceeds can itself be divided into two subparts—one for the "cost recovery income" from that portion of the reinvested proceeds and one for the "discount income" produced by that portion of the reinvested proceeds. The second subpart of the "appreciation income" is referred to in this Article as the "discount appreciation income."

If, as previously suggested, an income tax on realized appreciation that is reinvested can be viewed as a tax on the amount that will be expended on

\footnote{101} Full consideration of depreciation policies is beyond the scope of this article.
\footnote{102} See Kahn, Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 Mich. L. Rev. 1, 57 (1979) (criticizing the view that tax depreciation should reflect an asset's decline in value).
consumption at a future date, the tax on an asset’s realized gain can be seen as a tax on the sum of the amount of the asset’s appreciation plus the “discount appreciation income” that is projected for the investment of the proceeds of that appreciation. In one sense, even when incurred by an individual, the tax subsequently imposed on the “discount appreciation income” actually produced by that reinvestment constitutes a double tax. The tax on the gain realized when an asset is disposed of incorporates a tax on the projected income that will be produced by the proceeds from that realized gain before they are used for consumption. Therefore, a tax on the subsequently earned income from the investment of the proceeds of that realized gain, that is, the “discount appreciation income,” amounts to a second tax on the same item. This tax treatment is merely an example of the bias created by an income tax system that favors current consumption over savings. The adverse influence of the tax system on the decision to save is exacerbated when the realized gain on the disposition of an asset and the appreciation income therefrom will be received in corporate solution so that they will be subjected to both a corporate income tax and a personal income tax.

When a corporation sells an appreciated asset for a gain the corporation will be taxed on that gain, and the shareholders also will be taxed when the proceeds of the sale are distributed to them or when they sell their stock. So long as the proceeds from the disposition of an asset are retained in corporate solution, the income stream produced by those proceeds will be subjected to the double taxation that applies to all corporate income. Thus, there will be double taxation on both the “discount appreciation income” and the gain recognized on the sale of the first asset. On the other hand, if a corporation distributes an asset to its shareholder, the subsequent income stream from that asset will be taxed only once to the shareholder. The double taxation of an asset’s income stream can be avoided by distributing the asset out of corporate solution. The question posed by the General Utilities doctrine is whether a distribution also can avoid the double taxation of the capitalized appreciation income of the asset.

It should be noted that except for the circumstance in which there has been a step-up in basis at a shareholder’s death, any appreciation of the corporation’s assets will be reflected as appreciation of a shareholder’s stock. The appreciation of a shareholder’s stock will be recognized by the shareholders upon the liquidation of the corporation or on the shareholder’s sale of his stock. Therefore, if a corporation distributes an appreciated asset to a shareholder, either the shareholder will recognize a gain thereby, or a predecessor shareholder previously recognized that gain on a prior sale of the corporation’s stock. The exception for a shareholder who acquired an increased basis at the death of a predecessor

103. See supra text accompanying note 31.

104. Because of other market influences and because of the fact that a minority shareholder cannot require that corporate distributions be made to shareholders, the amount of income or appreciation in value of the corporation’s assets is not necessarily matched dollar for dollar by an identical increase in the value of the shareholders’ stock. For closely-held corporations in which the same family owns the controlling interest, the match between the appreciation of the corporation’s net worth and of the value of its shares is likely to be fairly close. In any event, when the corporation is liquidated, the value of the outstanding stock will equal the net worth of the corporation less any transactional costs incurred in effecting the liquidation.
shareholder is merely an aspect of the operation of section 1014—namely, that unrealized appreciation of a decedent may escape taxation. Similarly, a shareholder who is a tax-exempt entity or a foreign person will not incur any federal tax liability, but those exceptions apply to income that is earned directly by such persons.105

Even if General Utilities remains dead, when the shareholder takes a stepped-up basis at death or when the shareholder is a tax-exempt entity or foreign person, there will be only one tax imposed upon the receipt of an appreciated asset; not the usual double tax. The reinstatement of General Utilities would reduce the single tax imposition in such cases to a zero tax. In the situation of the ordinary shareholder, the General Utilities doctrine will reduce what would have been a double tax incidence to a single tax. There is no meaningful difference between reducing a single tax to no tax on the one hand and reducing a double tax to a single tax on the other hand. In either event, the doctrine prevents the imposition of a corporate tax on the unrealized appreciation of a distributed asset.

Where a shareholder is not taxed on a distribution, it is attributable to tax policies that operate independently of the question of what is the proper tax base against which to apply the corporate tax. It is worth noting that the General Utilities doctrine operates primarily, and perhaps almost exclusively, on closely-held corporations.106 It seems unlikely that many shareholders of closely-held, family corporations are foreign persons or tax-exempt shareholders.

When a corporation distributes an appreciated asset to a shareholder, current law requires the corporation to recognize gain. As explained earlier, that gain typically will be taxed both to the corporation and to the shareholder (or to a predecessor shareholder).107 The future income stream, which the gain represents, will be taxed to the shareholder and will escape double taxation. Prior to the distribution, the corporation was taxed on the income produced by the asset, but was not taxed on the unrealized appreciation of the asset. A question remains as to whether the corporation should be taxed on the capitalization of the future income stream that will be received by the shareholders when the corporation has not received the value of that appreciation as some form of payment.108 The General Utilities doctrine prevented the recognition of gain by the corporation and taxed the appreciation of the asset only once—to the shareholder when the distribution was received (or to a previous shareholder who sold the stock). By

105. Nolan, supra note 14, at 103.
106. See id. at 101.
107. See supra text accompanying notes 104-06. Exceptions to this rule arise where the shareholder's basis in his stock has been stepped-up under I.R.C. § 1014 (1987) and where the shareholder is either a foreign or a tax-exempt person.
108. In a liquidation or stock redemption, the corporation either receives or is deemed to have constructively received its own stock in exchange for the distribution, but the acquired stock has no value to the corporation, especially when received in connection with a complete liquidation of the corporation. Regardless of whether the actual or constructive receipt of its own stock is a significant enough event to satisfy the minimal requirements of realization, a policy issue remains. The unanswered question is whether it comports with good tax policy to require the corporation to recognize an otherwise unrealized gain. This question is independent of the inquiry into whether the possible constitutionally mandated realization requirement has been satisfied. In no sense has the appreciation been severed from the asset in a manner beneficial to the corporation.
repealing *General Utilities*, Congress has required that the unrealized appreciation be taxed twice and has permitted the subsequent income stream to be taxed only once.

It is reasonable to allow the future income stream to be taxed only once to the shareholder because the removal of the asset from corporate solution eliminates any prospect of using the corporate entity as a shielding device to defer a shareholder's tax liability. The justification for subjecting the unrealized appreciation of the distributed asset, which appreciation represents a capitalization of the income stream to be enjoyed by the shareholder, to double taxation is not apparent. Similar considerations to those that permit the removal of the future income stream from double taxation suggest that the unrealized capitalization of that income stream also should escape double taxation. The pragmatic considerations that underlie the adoption of a double tax system for corporate income are considerably less compelling when applied to unrealized appreciation.

If a corporate distribution to its shareholder is deemed analogous to an individual's expenditure for consumption, a conceptual justification for taxing the corporation on the amount of appreciation of the distributed asset may exist. Under the conduit view of a corporation, the analogy between a corporation's distribution and an individual's consumption is invalid. The distribution of corporate assets to a shareholder, who is the beneficial owner of the asset under the conduit view, is not related to the consumption enjoyed by an individual. Even if the conduit view is rejected, the analogy to consumption is strained.

When an individual puts an appreciated asset into a corporation by way of a contribution to capital or a transfer to a controlled corporation in exchange for stock, the unrealized appreciation then becomes subject to the normal corporate taxation rules including the double tax incidence. The transferor recognizes neither a gain nor a loss in the transfer, even if the exchange is for stock. The corporation's basis in the asset equals the basis that the transferor had, and the transferor's basis in the corporate stock received in the exchange is the same as his basis in the asset that he transferred. Thus, the appreciation, which arose in the hands of the individual shareholder, becomes taxable both to the corporation and to the shareholder. Rather than separate the appreciation that arose in the shareholder's hands from appreciation that arose in the corporation's hands, the tax law combines them. Because the income produced by the contributed asset will be received in corporate solution and will be subjected to double taxation, the unrealized capitalization of that future income stream also will be subjected to double taxation. The price of contributing appreciated property to a corporation is the imposition of double taxation thereon.

Similarly, if an individual contributes a depreciated asset to a controlled corporation in exchange for stock, there can be a double allowance for the loss recognized on that depreciated element. The corporation takes the same basis in the contributed asset as the shareholder, and the corporation will recognize

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111. *Id.* §§ 358(a), 362(a).
The stock that the shareholder acquired in exchange will have the same basis that the shareholder had in the contributed asset, and the stock will also be a depreciated asset. If the shareholder sells that stock, he will recognize a loss. The tax law accepts the double allowance of a loss as the price of adhering to the double tax scheme once an asset is in corporate solution.

The General Utilities provision for single taxation of appreciation on an asset distributed by a corporation to its shareholders is consistent with the treatment of assets contributed to a corporation. In either case, the appreciation treatment would depend upon the distributee of the asset, who is the party that will realize the income stream, rather than upon the distributor. Of course, parallel treatment is not always provided by the tax law. But, in the absence of a good reason for different treatment, parallel treatment has visceral appeal. The current law's rejection of General Utilities is incompatible with the treatment accorded to contributions to corporations, and no good reason is apparent for this inconsistency. Indeed, in that regard, it is noteworthy that where a depreciated asset is distributed to a shareholder, Congress is ambivalent about allowing the corporation to recognize a loss.\textsuperscript{112}

One negative consequence of requiring a corporation to recognize a gain on the distribution of an appreciated asset is that the recognition will cause tax consequences at a time when the gain, which would make funds available to pay the tax, has not been severed from the asset. That objection could be met by allowing the nonrecognition of such gain subject to the distributee's taking a carryover basis in the distributed asset—that is, the distributee's basis in the asset would be the same as the basis that the corporation had. There is reason to believe that the Treasury Department is contemplating a proposal to amend the Code to provide some type of nonrecognition and carryover basis. While that meets the objection of imposing a tax liability before the gain is severed,\textsuperscript{113}

\begin{itemize}
\item \textsuperscript{112} To prevent the "stuffing" of depreciated assets in a corporation that is about to liquidate in order to obtain a double loss allowance, the corporation will be denied a deduction for a loss that is attributable to the amount of depreciation of an asset that was contributed to the corporation for the principal purpose of having the corporation recognize the loss in connection with its liquidation. \textit{Id.} § 336(d)(2). This disallowance of a deduction applies only if the transferor had a prohibited purpose for transferring the asset to the corporation. The asset must have been transferred to the corporation as a contribution to capital or as part of a § 351 exchange for stocks and securities of the corporation. \textit{Id.} If the asset was contributed more than two years prior to the date on which the corporation adopted its plan of liquidation, the loss almost certainly would be allowed because it would be difficult to prove that the transfer was made for a prohibited purpose. Blue Book, \textit{supra} note 16, at 343. A loss deduction also is denied for certain liquidating distributions of depreciated property, I.R.C. § 336(d)(1) (1987), but that provision can easily be avoided by selling the property and distributing the proceeds or by distributing the property only to shareholders who (after applying attribution rules) own less than 50%, in value, of the corporation's outstanding stock. It is noteworthy that in its Final Report on Subchapter C, the staff of the Senate Finance Committee proposed an amendment to § 358(a)(2) so that when a depreciated asset is contributed to a corporation, the corporation's basis in that asset would be limited to its fair market value. \textit{STAFF OF SENATE COMM. OF FINANCE, 99TH CONG., 1ST SESS., FINAL REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985} 220 (Comm. Print 1985). The proposal was not adopted.
\item \textsuperscript{113} No loss is recognized to a corporation making a nonliquidating distribution of depreciated property. I.R.C. § 311(a) (1987). A loss is recognized to a corporation on making a liquidating distribution of depreciated property, but there are several exceptions denying the recognition of the loss in certain circumstances. See \textit{id.} §§ 336(a), (d).
\end{itemize}
it continues the policy of subjecting the unrealized appreciation to a double tax. The shareholder will be taxed on the appreciation of his stock when he receives the distribution of the appreciated asset, or a predecessor shareholder previously will have recognized the gain as a consequence of a sale of the corporation's stock, and the shareholder-distributee will be taxed a second time when he disposes of the distributed asset. The principal issue is whether double taxation is proper for such unrealized gain. Only if the answer is affirmative does the question of the timing of recognition become an issue.

One objection to the General Utilities doctrine is that it permits the step-up in basis of a corporation's appreciated asset even though the gain will be subjected to only a single tax. So long as the income stream from the asset or the investment of the proceeds from the sale of the asset is in the hands of an individual, this article suggests that there is a conceptual basis for imposing only one tax. However, what if the individual shareholder contributes the asset or proceeds from its sale to another corporation? The subsequent income stream from the asset or the proceeds will be in corporate solution and thereby will be insulated from the tax schedule for individuals. If the second corporation is in a lower tax bracket than the individual, the potential for deferral has not been eliminated. The price for this deferral is that the taxable income from the income stream of the second corporation will be subjected to double taxation when distributed to the shareholder. In addition, there is a doctrine of long standing that addresses this problem. If a shareholder contributes the assets that he received as part of a liquidating distribution to a second corporation, the transaction may be recharacterized as a reorganization or as a reincorporation. While that doctrine is not always invoked successfully, it is a substantial restraint on the use of liquidations as a device to step-up the basis of assets. The doctrine also is the main line of defense against the use of a liquidation as a device to terminate undesirable tax attributes of a corporation such as its accumulated earnings and profits. In light of the double taxation of the second corporation's income, the question of whether the reincorporation doctrine will be applied to such transactions is of small consequence to the tax policy issue.

Several commentators have disputed the contention that General Utilities serves as a useful escape valve from the failure of Congress to integrate corporate and personal income taxes. For example, prior to TRA 1986, Professor Wolfman decried the value of General Utilities as a partial integration system. Professor Wolfman asks:

Is our present [General Utilities] 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?

118. Id.
Professor Yin adopted the same objection to this doctrine.119

The attack by Wolfman and Yin on the doctrine suggests that it operates arbitrarily so that there is no more reason to provide relief from nonintegration for distributed appreciated assets than there is for gain recognized during the life span of a corporation. Contrary to that suggestion, as noted above, there is a conceptual basis for not requiring the double taxation of unrealized appreciation of an asset that is distributed out of corporate solution, especially if it is a liquidating distribution. That is not to say that a conceptual justification for the General Utilities doctrine is a sufficient reason to reinstate the doctrine. The value of the doctrine must be measured by balancing the benefits that it provides against the costs that it imposes. This Article discusses those benefits and costs below.120 Before doing so, the view advanced by Wolfman and Yin deserves further comment.121

Assuming that tax policy favors integration and that an unintegrated tax system is the product of political expediency, then any partial integration system necessarily will provide only incomplete relief. Incomplete relief will have an arbitrary aspect in that it does not help those persons who do not qualify for it. The inequity in such circumstances does not stem from the fact that some relief is provided. Rather, it stems from the fact that the problem at which the partial relief was aimed has not been eliminated completely. Given that Congress is not ready to move to an integrated system, the question is whether there are conceptual and economic considerations that make the imposition of a double tax on distributed unrealized appreciation even more inappropriate than is the imposition on recognized corporate income. Criticizing a relief measure because it does not go as far as it might is not helpful. The issue is the age-old one of whether half a loaf is worse than none. There is no universal answer to that question. The merits and costs of each measure must be examined and weighed.

The unintegrated corporate tax is the price that the federal government exacts for the privilege of doing business in corporate form. It is far from obvious that the purpose and integrity of that unintegrated tax dictate that it be extended to reach the unrealized appreciation of a distributed asset. The proponents of the repeal of General Utilities begin with a presumption that the tax should be extended and, therefore, place the burden of persuasion on those who favor the doctrine. There is no compelling reason for imposing the burden of persuasion on those who support the doctrine rather than on those who favor its repeal. Regardless of where the burden rests, the case for the reinstatement of the General Utilities doctrine is a strong one.

It should be noted that the General Utilities doctrine deals with the type of action taken by a corporation rather than with the type of corporation. Under that doctrine, any corporation that has an asset with unrealized appreciation can avoid double taxation of that appreciation by distributing the asset to its shareholders or by liquidating. There are many circumstances in which a corporation will not be willing to take either of those actions and so will not qualify for

119. Yin, supra note 114, at 1114.
120. See infra text accompanying notes 122-52.
121. Apparently, neither Professor Wolfman nor Professor Yin favors integration. Their contention is that even if one is an integrationist, a case cannot be made for the General Utilities doctrine. It is that contention that this Article wishes to address.
the relief. While that is regrettable, the cause of the difference in tax treatment is at least as much due to the failure of Congress to integrate corporate and personal taxes as it is to the integration of the tax burden on distributed unrealized appreciation.

B. The Benefits and Costs of Reinstating All or a Portion of the General Utilities Doctrine

The author believes that the above analysis of the conceptual framework of the unintegrated tax system strongly suggests that the General Utilities doctrine should be reintroduced to Subchapter C of the Code. The case for the inclusion of the General Utilities doctrine is strongest if the conduit view of corporations is adopted. As noted below, virtually only closely-held corporations distribute appreciated assets to their shareholders, other than distributions made pursuant to a reorganization or corporate division to which the General Utilities doctrine has no application. Even critics of the conduit view concede that it is an accurate description of closely-held corporations. Consequently, a conceptual analysis strongly favors the adoption of the General Utilities doctrine. However, the substantial national deficit suggests it is unlikely that Congress will be persuaded on the basis of a conceptual analysis, regardless of its strength. The likelihood that General Utilities will be reinstated rests ultimately on cost-benefit considerations rather than on a conceptual analysis.

The most important benefits a reinstatement of the General Utilities doctrine would provide are a decrease in the tax bias against those businesses choosing to operate as "C" corporations and a reduction in the discriminatory treatment of those businesses that are compelled to operate in the "C" corporate form. If the doctrine were readopted and limited to liquidating distributions, the relief would benefit primarily closely-held corporations because very few publicly-held corporations are liquidated. In the author's view, even if the doctrine were made applicable to dividends and other nonliquidating distributions, closely-held corporations would be the principal beneficiaries of the measure since publicly-held corporations rarely make distributions of property in kind, other than distributions that are excluded from income recognition by the reorganization or corporate division provisions. Tax relief is most important for the closely-held corporation because it is primarily closely-held businesses that have the option to choose a partnership form for the conduct of the business. The relief from an unintegrated tax will reduce the extent to which tax considerations will govern the choice of business form.

122. See infra text accompanying note 124.
123. See sources cited infra note 124; see also M. Norr, supra note 68, at 9-13, 35 (noting that widely-held corporations are sufficiently different from closely-held ones that a single tax system for both does not operate well).
124. See Nolan, supra note 14, at 101. Professor Yin has questioned the accuracy of the above statement because of reports that a few publicly-held corporations sought relief from the repeal of General Utilities. Yin, supra note 114, at 1118 n.72.
125. The nonrecognition provisions that apply to qualified corporate distributions are set forth in §§ 311(a), 336(c). I.R.C. §§ 311(a), 336(c) (1987); see also id. §§ 355, 361 (providing for nonrecognition for certain distributions of stock and securities of a controlled corporation and for any gain or loss to the transferor corporation). These nonrecognition rules will apply regardless of whether General Utilities is reinstated.
This Article suggests that it would be undesirable to target only closely-held corporations for a legislatively adopted provision for nonrecognition of a corporation’s unrealized gain on a distribution. There are conceptual and economic grounds for not taxing such gain to publicly-held corporations, although the case is not as strong as is the case for closely-held corporations. In addition, any division between publicly-held and closely-held corporations will be based on the drawing of an arbitrary line, and regardless of where the line is placed there will be some corporations that fail to qualify for General Utilities treatment and yet fit within the class of enterprises at which the relief is aimed. For example, if a closely-held corporation was defined as one with fewer than thirty-six shareholders, it is easy to conceive of corporations with thirty-six shareholders for which a partnership form is a viable option.

Bright line drawing necessarily causes some arbitrary impact. Such line drawing, however, is employed in the Code in order to obtain the benefits of a provision that is easy to administer and predictable in application with some degree of certainty. In this case, there is little justification for bright line drawing because there are not likely to be many publicly-held corporations that would benefit from this relief, and there are reasonably strong reasons to cover those few publicly-held corporations that would benefit from such relief. In any event, legislative and administrative complications caused by such line drawing, the likelihood that making such a differentiation will preclude relief to corporations that fall within what should be the protected class, and the fact that there are few, if any, corporations that make distributions of appreciated property that should be excluded from the relief provision combine to make it undesirable to limit the relief provision to corporations of less than a specified size.

Some of the critics of the General Utilities doctrine have questioned why, if partial integration relief is desirable, the relief should be aimed solely at liquidating distributions. Why should not the relief be granted as a subsidy to the corporation during its existence or granted in the form of lower corporate tax rates? Why favor dead corporations and deny relief to those that are thriving? These questions were raised before the General Utilities doctrine had been repudiated and after the doctrine essentially had been restricted to liquidating distributions. Later, this Article will address the question of whether the doctrine should be limited to liquidating distributions. If not, no doubt the same

126. For example, for a corporation to qualify for a Subchapter S election, it must have fewer than 36 shareholders. Id. § 1361(b)(1)(A).
127. If the number of shareholders is to be restricted, rules will have to be adopted for dealing with stock held by other entities and for stock held by spouses or by other family members. While a variety of such rules have been adopted in other areas of the Code, they add complex provisions to the statute and have caused interpretive problems. Different rules of this type have been fashioned for various provisions in order to deal with the disparate goals of the several provisions to which they apply. For example, in the Subchapter S provision, spouses are counted as a single person, and most types of trusts are prohibited from holding stock if the corporation is to qualify as an “S” corporation. Id. §§ 1361(b)(1)(B), (c)(1). A different approach with respect to trusts would have to be designed for the General Utilities provision, and the one-shareholder rule might be expanded to cover certain other members of a family.
128. Wolfman, supra note 117, at 85; Yin, supra note 114, at 1119.
129. Yin, supra note 114, at 1119.
130. See infra text accompanying notes 158-60.
objections that have been made to the treatment of liquidating distributions will be made to nonliquidating distributions of property in kind. Let us first consider these issues as they relate to liquidations.\textsuperscript{131}

It is unlikely that the subsidization of operating corporations, even small ones, is politically feasible. Certain small operating corporations are, arguably, subsidized by applying lower corporate tax rates to the first $75,000 of their taxable income, but the public does not regard the lower rates as a subsidy. While the TRA 1986 lowered corporate tax rates, the Act also lowered the tax rates on individuals. As a result, corporate rates typically are higher than individual rates. This disparity of rates, greatly aggravated by double taxation of corporate income, is one of the features that tilts the choice of business form away from "C" corporations.

On the other hand, the elimination of a corporate tax on unrealized appreciation is more saleable politically. There are conceptual grounds for excluding unrealized appreciation. Many people have a favorable visceral reaction to such an exclusion because it comports with general tax policy regarding realization.

The problem that General Utilities addresses is that the prospect of incurring double taxation deters investments in corporate form. This deterrence is analogous to the tax bias that operates on savings, rather than consumption.\textsuperscript{132} The bias against savings arises because of the double taxation of income earned from the investment of savings.\textsuperscript{133} This treatment operates to deter capital investments and favor consumption.

For many years prior to the adoption of TRA 1986, the tax law mitigated the bias against capital investments by providing preferential tax rates for capital gains.\textsuperscript{134} The benefit of those preferential rates was not enjoyed until the asset was sold or exchanged. The investor understood that if the net amount retained on liquidation of the investment was increased, the expected return on the investment was higher. The mitigation of the tax bite imposed upon liquidation of the investment was of current benefit to an investor because it made the investment more marketable. The resale value of a new asset often affects the price of the asset. A new car that is a brand of automobile that has a good used market record will sell for more than otherwise would be the case.

An investor who is considering whether to operate a business in corporate form will wish to take into account the net amount of after-tax return that can be projected for the enterprise. The imposition of a tax on unrealized appreciation on the liquidation of a corporation is one of several tax deterrents to operating in that form. The sum of these tax deterrents has to be balanced against any nontax benefits that can be obtained. If one of the major tax deterrents is removed, the value of nontax benefits that need to be present to justify doing

\textsuperscript{131} This Article subsequently will consider nonliquidating distributions. See infra text accompanying notes 158-60.

\textsuperscript{132} See supra note 32 and accompanying text.

\textsuperscript{133} Id.

\textsuperscript{134} While TRA 1986 eliminated preferential rates for net capital gains, the Act provides for a reintroduction of that preference if the normal tax rates should rise at a subsequent date. I.R.C. §§ 1(j), 1201(a) (1987).
business in corporate form is reduced. It is true that the adoption of the *General Utilities* doctrine will not eliminate the tax bias against incorporating, but it will mitigate the tax bias. In view of 1) the conceptual justification for that doctrine and 2) the political reality that an alternative form of relief from the tax bias is unlikely to be adopted in the foreseeable future, there is considerable merit to reinstating the doctrine. The targeting of corporate liquidations—and possibly of current nonliquidating distributions in kind—for relief is no less reasonable than was the preferential rate for capital gains, albeit the conceptual grounds for those two relief measures differ in some respects.

The exclusion of unrealized appreciation from double taxation does discriminate against corporations that sell their appreciated assets and thereby realize the appreciation. This discrimination, however, is inherent in the realization doctrine. If *X* corporation purchases a widget for $10 and if the widget subsequently appreciates in value to $15 because of an increase in income produced by it, *X* will not be taxed on that appreciation so long as *X* does not sell the widget. If *X* sells the widget for $15 and invests the proceeds in a gidget that produces the same income stream as did the widget, *X* will be taxed on the $5 of appreciation that he realized on the sale of the widget. This discrimination has long been a part of the tax law and has not seriously been attacked.

The determination that unrealized appreciation of a corporate asset should be treated differently from realized appreciation so that the former will be taxed only once and, therefore, will escape double taxation is hardly a revolutionary concept. The issues are whether the structure of Subchapter C of the Code would be abused by failing to apply the corporate tax to that appreciation and whether there is an economic justification for doing so. This Article has endeavored to demonstrate that the exclusion of unrealized appreciation from the corporate tax is more consistent with the structure of Subchapter C than the double taxation of that appreciation. The author also believes that there are economic justifications to provide some relief from the unintegrated tax system.

Many tax commentators regard the realization doctrine as an inconvenient nuisance that interferes with the income tax system's capacity to measure annual income accurately. For them, realization should take place at the earliest date that it is convenient to measure it. Understandably, one who holds that view would reject the *General Utilities* doctrine that permits a corporation to escape corporate taxation of the appreciation of an asset that took place in its hands. Although it will not always be so, the appreciation of an asset that is held by a corporation typically will be attributable to appreciation that occurred while the corporation—or a predecessor corporation—held the asset. The undesirability of imposing a corporate tax on such unrealized appreciation rests more on a desire to limit the scope of the double tax system that applies to corporate income than it does to the sanctity of the realization doctrine. If, as this Article suggests, whatever pragmatic justification there may be for an unintegrated corporate tax does not exist once the income-producing asset is removed from corporate solution, then there is no reason to take extraordinary measures to accelerate the realization of appreciation so that it can be taxed twice.

It is interesting to note that when shareholders are contemplating the cash sale of an incorporated business, the repeal of the *General Utilities* doctrine creates a tax bias in favor of selling the corporation's stock rather than having the corporation sell its assets followed by a liquidation of the corporation. The reason that the double tax system creates that bias is because of the time value of money.

Consider a proposed sale of a corporate business to a publicly-held "C" corporation in the circumstance in which the *General Utilities* doctrine has been repealed and in which there are assets in the target corporation that are appreciated in value. Further, assume that the target corporation and the purchasing corporation are in the thirty-four percent tax bracket—the maximum rate applicable to corporations. Finally, assume that the shareholders of the target plan to take cash out of the sale—that is, if the target's assets are sold, the target will be liquidated—and that the purchasing "C" corporation intends to retain the target's assets for some years. At first blush, the rule requiring the double taxation of unrealized appreciation appears to make it irrelevant whether the target sells its assets, thereby recognizing income for its unrealized appreciation, and promptly liquidates or whether the shareholders of the target sell their stock so that the basis of the target's assets remain unchanged and the purchasing corporation will incur the same tax liability either as a recognition of gain when the target disposes of the appreciated assets or in the form of reduced depreciation if the assets are retained and are depreciable.

For example, assume that the target corporation holds a nondepreciable asset with a fair market value of $400,000 and the target has a basis of $0 in the asset. If the target sells the asset for its value, it will recognize a gain of $400,000 on which the corporate tax, at a rate of thirty-four percent, will be $136,000. That will leave a net of $264,000 for the corporation to distribute to its shareholders as a liquidating distribution. The shareholders will receive $264,000 in liquidation of the target, and they will pay tax on the gain they recognize from that distribution. If the purchasing corporation subsequently sells the asset for $400,000, it will not recognize a gain because it will have a basis of $400,000 in the asset.

On the other hand, if the purchasing corporation buys the target's stock, it will incur a tax on a $400,000 gain if the target subsequently disposes of the asset at that price. The tax on that gain at a thirty-four percent rate will be $136,000, and the target (and therefore the purchasing corporation) will net only $264,000 from the sale. It might seem that the purchasing corporation would pay only $264,000 for the number of shares of the target's stock that is attributable to the $400,000 asset because that is all that the purchasing corporation can net from the sale of that asset. However, the $136,000 potential tax liability does not have a cost of that same amount to the purchasing corporation. The


137. When the purchasing corporation buys the stock of the target, the target's basis in its assets will be unchanged unless an election is made under § 338 to treat the target as if it had sold all of its assets and recognized the gain on any appreciation thereon. If the target recognizes a gain on a subsequent disposition or on a § 338 election, the tax payable by the target will reduce the value of its stock that is held by the purchasing corporation. Thus, the incidence of the tax on the target will fall upon the purchasing corporation.
tax liability will not be incurred by the purchasing corporation until that future date on which the disposition of the asset is made. The present value of a liability payable at what might be a distant future date is less than the amount of dollars payable when the liability accrues. The purchasing corporation, therefore, should be willing to pay more for the target’s stock than the $264,000 that the shareholders would net if they had the target sell its assets to the purchasing corporation for $400,000. In other words, if the target corporation sells the asset to the purchasing corporation and then liquidates, the corporate tax liability for the asset’s appreciation will be payable currently. But, if the target’s stock is sold, the corporate tax liability will not be payable for some years and the deferral has substantial value. Thus, when the asset is nondepreciable, there is a tax-created bias in favor of having the shareholders of the target sell their stock.

What if the $400,000 asset is depreciable? The sale of the target’s stock will leave the target with a zero basis and so it will provide no depreciation allowance against the income stream produced by the asset. In contrast, if the assets of the target are sold, the purchasing corporation would have a $400,000 basis to depreciate over the recovery period of the asset. Because the depreciation deductions will be spread over the recovery period of the asset, the present value of the aggregate tax reduction obtained from such deductions is less than the tax that would be paid by the target if it sold the asset directly to the purchaser.

As a consequence of the manner in which depreciation deductions for certain assets are determined, the discrepancy between the tax treatments of asset sales and stock sales is greatly enhanced. The present value of a depreciation deduction decreases as the amount of time before the deduction can be taken increases. Therefore, the more accelerated a method of depreciation, the less will be the difference between the amount of tax payable by the target on a sale of its assets and the present value of the projected tax loss that will be suffered by the purchasing corporation if instead it buys the target’s stock. Many types of depreciable assets cannot be depreciated on an accelerated method. Under the current tax law, accelerated depreciation is available generally for tangible personal properties, but it is not available for most improved realty or for intangible properties.

To illustrate the operation of the bias where depreciable property is concerned, consider the earlier example of a target that holds an asset with a market value of $400,000 and a basis of zero. Assume that the asset is a nonresidential building on leased land, which must be depreciated on a straight-line basis over a recovery period of thirty-one and a half years. Assuming that the asset would be purchased by the purchaser on January 1, the annual rate of depreciation for the asset is a little more than three percent. Further, assume that the

138. An accelerated method of depreciation is a depreciation method in which the depreciable basis of an asset is allocated among the years of its recovery period so that a greater proportion of the total amount of depreciation for the asset’s life is allocated to the earlier years of the asset’s life than is allocated to its later years.
140. Id. §§ 168(b)(3), (c).
$400,000 building produces an annual net income of $40,000. The building, therefore, was valued by capitalizing its annual income by a factor of ten.

If the purchasing corporation buys the building from the target for the market price, it will have a basis of $400,000 in the building. Each year, the purchaser will receive net income of $40,000 and it will deduct depreciation of about $12,000. The purchaser will report net taxable income of $28,000 on which it will pay a tax of $9520. Therefore, after taxes, the purchaser will net $30,480. Because the purchaser is willing to pay $400,000 for an after-tax return of $30,480, a capitalization factor of more than thirteen is realized for the after-tax income from the building.

If, instead, the purchasing corporation was to buy the target’s stock and does not utilize section 338 to cause the recognition of the unrealized appreciation of the building, it will be taxed on the full $40,000 of annual net income that it receives because it will not have any depreciation allowance. Note that the purchasing corporation can obtain the target’s income without incurring an additional tax by either: (1) Filing a consolidated return with the target, or (2) having the target distribute its net income as a dividend for which a one hundred percent dividend received deduction is available under section 243(a)(3), or (3) liquidating the target under section 332. The tax payable on $40,000 of income at a thirty-four percent rate is $13,600. Thus, the purchaser will net after taxes only $26,400. This net after-tax figure is $4080 less than the purchaser would receive if it purchased the building directly. Obviously, the corporation will not pay $400,000 for the target’s stock since it will net a smaller after-tax amount than it would obtain if it bought the building directly for $400,000. The question is, how much less than $400,000 will it pay? If the purchaser will pay more than $264,000 for the stock, the shareholders are better off to sell the stock than they would be if the target sold the building.

Returning to the net income after taxes that the purchasing corporation would receive if it purchased the building directly from the target, recall that the purchaser would net $30,480 annually and that, using that net income figure, a capitalization factor of thirteen yields the purchase price of $400,000. It would seem reasonable then to use a capitalization factor of thirteen to determine how much the purchasing corporation would pay for the target’s stock. Because, in that event, the building would produce after-tax annual income of $26,400, a capitalization factor of thirteen will justify a purchase price of $343,200. If so, that provides a substantial profit for the shareholders to sell the target’s stock rather than to have the target sell the building directly. In fact, it is likely that the purchase price for the target’s stock will be somewhere between $264,000 and $343,200, but it should be closer to the latter figure than the former.

This bias for a stock sale occurs because the present value of the additional tax liability that will be incurred by the purchaser in subsequent years as a result of the loss of depreciation deductions that would have been allowed in those years if an asset sale had taken place is less than the aggregate amount

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142. $400,000 X 3%
143. $28,000 X 34%. Recall that both the purchasing corporation and the target are in the 34% tax bracket.
144. $40,000 - $9520.
145. $30,480 X 13.12 = $400,000.
of such increases in tax liability. The greater the acceleration permitted for
depreciation deductions, the less the bias will be.\textsuperscript{146}

The tax law does provide significant acceleration for the depreciation of
tangible personal properties. Only straight-line depreciation, however, is allowable
for most improved realty and for intangible assets.\textsuperscript{147} Especially in those
circumstances in which a target's realty and intangible assets predominate, there
will be a strong tax bias for selling the target's stock. Also, the bias operates
on nondepreciable assets of the target and is especially strong in the case of a
nondepreciable asset, such as the goodwill of the business, that may never be
disposed of by the purchasing corporation because the purchaser may not place
much value on the basis that it can acquire in such an asset by purchasing it
directly.

One objection to permitting a lower tax rate for selling a target's stock is
that it creates a difference in tax treatment for one method of conducting a
sale when the distinction between the alternative methods of sale is merely a
formal one. This creates a trap for the unwary taxpayer who chooses one method
without knowing the tax consequences. The Code already contains a multitude
of such traps, but it cannot be regarded as desirable to expand them. A second
objection is that financial and economic considerations point towards a preference
for selling the corporation's assets rather than a stock sale. In an asset sale,
the purchaser knows what liabilities he has undertaken. In contrast, in a stock
sale, the purchaser may become liable for undisclosed or latent liabilities. An
asset purchase, therefore, may be more efficient. It is undesirable to have the
tax system nudge the transaction towards a stock sale.

If a target were not required to recognize gain on a liquidating sale or
distribution of its assets, there would be no difference in the tax consequences
of selling the target's assets or of selling the target's stock. With a few exceptions
(e.g., the income recognition required for recapture of depreciation and for
LIFO recapture), that was the case before the TRA 1986 eliminated most of
the \textit{General Utilities} doctrine. So, the tax bias favoring the sale of stock arose
primarily as a consequence of the 1986 Act.

One means of preventing the repeal of \textit{General Utilities} from creating a
tax bias is to require that the target recognize gain for any unrealized appreciation
when a certain percentage of its stock is sold. This could be accomplished by
making section 338 of the Internal Revenue Code of 1986 mandatory instead
of elective. That seems a drastic solution to a problem that is generated by the
repeal of a rule that should never have been repudiated. If it is necessary to
make section 338 mandatory in order to cure one of the flaws in the repeal of
\textit{General Utilities}, there is not much left to the claim, noted below, that the
repeal will simplify the Code.

Professor James B. Lewis recently has proposed the adoption of a system
called \textit{Uniform Corporate-Level Recognition} (UCLR) that would require a target
to recognize gain on its asset appreciation when a certain percentage of its

\textsuperscript{146} The fact that in such cases there will be less depreciation allowable for the later years
of the asset's life will not offset the allowance of a greater amount of depreciation in the early
years. This is so because of the time value of money.

\textsuperscript{147} I.R.C. § 168 (1987).
outstanding stock is sold. 148 If adopted, the UCLR system would introduce at least as much complexity as section 338 raised and very likely would cause even greater complexity than section 338 did. 149

A major cost of the General Utilities doctrine is that it is the source of some complex provisions in the tax law that are designed to prevent the abusive use of that doctrine to obtain a tax windfall. The reincorporation doctrine and the collapsible corporation provision are two illustrations of such complex provisions that have been mentioned by opponents of General Utilities. 150 Unfortunately, TRA 1986's elimination of the General Utilities doctrine has not yet led to wholesale abandonment of the many complex provisions that deal at least partially with that doctrine. One reason for this is that many of those complex provisions are not directed exclusively at General Utilities. The reincorporation doctrine, for example, also prevents the use of a liquidation to terminate unfavorable tax attributes, and the collapsible corporation provision is aimed primarily at the effort to convert ordinary income into a capital gain.

It is undisputed that the General Utilities doctrine has engendered complexity, but it is doubtful that a great amount of simplification will result from its repeal. The crucial question is whether the equitable aspects of the doctrine and the economic benefits it can provide offset the cost of keeping complex rules that otherwise could be eliminated. There is no simple answer to that question. It depends in part upon the importance attached to tax law simplification and in part upon the value attached to the doctrine. In addition, whether or not the capital gains preference is reinstated, if the differential between capital gain rates and ordinary income rates is relatively small, much of the complexity surrounding General Utilities can be eliminated. 151 Finally, in valuing simplification,
it is noteworthy that in recent years neither the Treasury nor the Congress has been deterred from proposing and passing enormously complex legislation to deal with some perceived problem. Simplicity has not been a high priority of tax legislation.

If General Utilities is reinstated, the provisions of the pre-1987 version of section 337 also should be readopted. There is little benefit to requiring the corporation to distribute its assets in liquidation so that the shareholder, who thereby obtains a stepped-up basis in the distributed properties, could sell them without recognizing a gain on that sale. While it is true that the corporation's sale of its properties causes it to realize any previously unrealized appreciation, the proceeds are held only for a transitory period in the course of the corporation's liquidation. The justification for allowing nonrecognition in such cases is to avoid unnecessary transactional costs that otherwise would be incurred.

Why did Congress choose in 1986 to repudiate the General Utilities doctrine? While it is speculation, one obvious reason was that it was a revenue raising measure that was included in the bill when Congress needed to find additional revenue in order to keep the TRA 1986 revenue neutral. Another reason is that Congress feared that the availability of General Utilities increased the incentive for corporate takeovers. Congress expressed that fear even though the Treasury found that takeover activity was not primarily influenced by tax considerations. Congress mentioned other considerations, but the two listed above appear to have been the dominant reasons.

C. Application of Nonrecognition to Nonliquidating Distributions and to Distributions of Noncapital Assets

The nonrecognition of unrealized gain should not be limited to liquidating distributions. Concededly, the case for excluding unrealized appreciation from

will be quite small—no greater than $20 per year ($1000 X 2%). It is unlikely that the purchasing corporation will reduce the purchase price of the target's stock much below the $1000 value of the book. As long as the discount that the purchaser applies is less than $162, the individual could profit from using the corporate form to transmute ordinary income into a capital gain. The collapsible corporation provision deals with this situation. While the Commissioner could use other doctrines to attack this transaction, the government has not always been successful in doing so. That is the reason the collapsible corporation provision was adopted.

Since TRA 1986 eliminated the capital gains preference, at least for the present, the collapsible corporation provision is not needed. Presumably, Congress did not repeal that provision, in part, because it was uncertain whether the capital gain preference and the General Utilities doctrine would reemerge in the tax law.

152. For example, consider the passive activity loss limitation provision, I.R.C. § 469 (1987), and the various provisions that deal with the time value of money, id. §§ 1271-1275, 7872. The recently promulgated first installment of proposed regulations for the passive activity loss and credit limitations numbers 266 pages.

153. The pre-1987 version of § 337 granted nonrecognition of gain or loss realized on the sale of certain assets by a corporation pursuant to a plan of liquidation that was implemented within a twelve-month period. I.R.C. § 337 (1986).


corporate taxation is strongest when the corporation is being liquidated, but the case for nonliquidating distributions is not substantially weaker. Essentially the same considerations that point to nonrecognition for liquidating distributions apply to current distributions of property in kind to individual shareholders. The distributed property is no longer in corporate solution and its income stream will be earned and received in the hands of an individual. The distribution of the asset constitutes a liquidation of the corporation's interest in that asset. Also, if General Utilities were reinstated only for liquidating distributions, there would be a lock-in tendency—that is, corporations would have a tax incentive not to dispose of an asset prior to liquidation. If the doctrine is extended to nonliquidating distributions, there will be no lock-in effect.

It is interesting that the House report on the bill that became TRA 1986 stated that economically a liquidating distribution is indistinguishable from a nonliquidating distribution. The House committee concluded from that equivalence that nonrecognition for liquidating distributions should be repudiated so that liquidating and nonliquidating distributions would be given the same tax treatment. That decision was grounded on the conclusion that the imposition of only a single tax on corporate distributions of appreciated property is a poor rule. If one concludes that only a single tax should be imposed, the pre-1986 treatment of nonliquidating distributions should have been brought in line with the treatment of liquidating distributions instead of the reverse.

If there is a significant difference between the tax rates imposed on capital gains and those imposed on ordinary income, there is reason to prevent the use of a corporate distribution as a means of shifting the tax characterization of a gain from ordinary to capital. This can occur because the gain recognized on corporate stock typically will be a capital gain regardless of the characterization of the assets held in the corporation. One simple means of preventing that abuse is to deny an exclusion of the corporate tax for the unrealized appreciation of distributed assets to the extent that gain from the sale of that asset would have been ordinary income to the corporation. However, if the tax rates on capital gains are equal to, or only slightly lower than, the rates on ordinary income, there is no reason to single out ordinary income assets for different treatment.

V. Conclusion

The question of whether the unrealized appreciation of distributed properties should be insulated from an unintegrated corporate tax is a more delicately balanced issue than most of the literature on that topic would suggest. On balance, however, this Article concludes that General Utilities not only should be reinstated, it should be restored to much of its original vigor.

158. Id. at 281.
159. Id. at 282.
160. Interestingly, the House committee expressed its view that the tax law should provide relief from the double taxation imposed on corporate income. Id. at 282.
161. There are some exceptions to that general rule. For example, the collapsible corporation provisions constitute an exception, but those provisions apply only in special circumstances. I.R.C. § 341 (1987).