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GENERAL UTILITIES’ LAST STAND

J. Ronald Shiff†

I. INTRODUCTION

For over half a century the General Utilities doctrine, under which gain was not recognized to a corporation which distributed appreciated property to its shareholders,¹ was enshrined in United States tax law. That doctrine created an inordinate amount of complexity in subchapter C of the Internal Revenue Code (the “Code”).² Similarly, there were numerous statutory and judicial exceptions to the doctrine which were designed to eliminate abuse.

The Tax Reform Act of 1986³ (TRA’86), through amendments to sections 311, 336 and 337, repealed the General Utilities doctrine. At first blush, the repeal of the General Utilities doctrine appears to be a long overdue change necessary to impart fairness and simplicity into the Code. A more careful examination, however, reveals that the TRA’86 has imparted a whole host of new inequities, ambiguities, and complexities.

This article traces the evolution of the General Utilities doctrine through the enactment of the TRA’86. It then explores the changes made by the TRA’86 including the transitional rules thereto. Particular emphasis is placed upon the new provisions which generate additional complexity and those areas which the Internal Revenue Service (the “Service”) will have to address in regulations.

II. BACKGROUND

A. The General Utilities Case

In General Utilities & Operating Co. v. Helvering,⁴ Petitioner purchased one-half of the outstanding stock of Islands Edison Company (“Islands”) for two thousand dollars on January 1, 1927.⁵ In January 1928, Southern Cities Utilities Company (“Southern”) considered ac-

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² For example, the collapsible corporation provisions, which purportedly contain the longest single sentence in the Code, would be unnecessary in the absence of the General Utilities doctrine. See, e.g., STAFF OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 89 (Comm. Print 1983).
⁴ 296 U.S. 200 (1935).
⁵ Id. at 201.
quiring all of the Islands' stock. Petitioner and Southern agreed that Petitioner would distribute the Islands stock to Petitioner's shareholders and that an agreement for sale of the stock would be submitted to the shareholders for approval. On March 22, 1928, Petitioner's board of directors declared a dividend of $1,071,426.25 payable in Islands stock. Four days later, all of Islands' shareholders sold their stock to Southern for $56.125 per share, the amount Petitioner's directors had previously determined to be the fair market value. The Commissioner of Internal Revenue (the "Commissioner") asserted that the distribution of the stock in satisfaction of the dividend was the satisfaction of a corporate debt with appreciated property and therefore resulted in a taxable gain of $1,069,517.25. The Board of Tax Appeals rejected the Commissioner's argument and held that the declaration and payment of the dividend did not result in taxable gain to the corporation.

Although agreeing that the dividend was not a cash dividend, the United States Circuit Court of Appeals for the Fourth Circuit reversed the Board of Tax Appeals on the grounds that:

The sale of the stock in question was, in substance, made by the respondent company, through the stockholders as agents or conduits through whom the transfer of the title was effected. The stockholders, even in their character as agents, had little or no option in the matter and in no sense exercised any independent judgment. They automatically ratified the agreement prepared and submitted to them.

On appeal, the Supreme Court agreed with both lower tribunals that the "assets were not used to discharge an indebtedness." The Court, however, reversed the Fourth Circuit's holding that the transaction was, in effect, a sale by the corporation since the Commissioner had not raised that argument.

While General Utilities has come to stand for the proposition that a distribution of appreciated assets by itself does not result in gain recognition at the corporate level, neither the Supreme Court nor the lower

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6. Id. at 201-02.
7. Id. at 202.
8. Id. at 202-03.
9. Id. at 203. The Commissioner's figure represented the value of the distributed stock, $1,071,426.25, less the taxpayer's basis in the 19,090 shares distributed, $1,909.00. The Board of Tax Appeals found that the taxpayer had not entered into an agreement with Southern to sell its Islands' stock except with respect to the 910 shares which it retained and sold on March 26, 1928. See 29 B.T.A. 934, 937-38 (1934), rev'd, 74 F.2d 972, rev'd, 296 U.S. 200 (1935).
12. Id. at 976.
14. Id. at 206-07.
courts ever directly ruled on the issue. Nevertheless, subsequent cases embraced the principle.

B. Codification of General Utilities

Congress codified the General Utilities doctrine in sections 311, 336, and 346 of the Internal Revenue Code of 1954 (the "1954 Code"). Section 311 applied to distributions to shareholders with respect to the corporation's stock, section 336 applied to distributions to shareholders of corporate assets in liquidation of the corporation and section 337 applied to distributions to shareholders following the sale of corporate assets in liquidation of the corporation.

As originally enacted, section 311(a) provided that "no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of (1) its stock (or rights to acquire stock), or (2) property." Congress recognized, however, that the broad rule of nonrecognition afforded opportunities for abuse. Accordingly, it enacted three basic exceptions to the nonrecognition rule so that taxpayers could not convert corporate level ordinary income into shareholder level capital gain. Gain or loss was recognized on distributions of installment obligations. A corporation would also have recognized gain or loss on the distribution of LIFO inventory. Finally, if a corporation distributed property sub-

15. As one commentator wrote:
   
   It has been argued that in rejecting [the satisfaction of indebtedness] argument, the Court must have assumed a fortiori that the mere distribution of appreciated property was not a taxable event; but there is a big difference between answering a question and assuming an answer in the absence of timely argument.
   
   B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 7.21 n.126 (4th ed. 1979) (hereinafter "BITTKER & EUSTICE").

16. See, e.g., Louisiana Irrigation & Mill Co. v. Commissioner, 14 T.C.M. (CCH) 1252 (1955); Southwest Consol. Corp. v. Commissioner, 5 T.C.M. (CCH) 6 (1946); Smith Bros. Refinery Co. v. Commissioner, 5 T.C.M. (CCH) 17 (1946).


18. The legislative history clearly demonstrated the congressional intent.
   
   The bill incorporates in the statute a rule derived from the Supreme Court decision in [General Utilities] that a corporation does not realize gain by reason of a distribution of its property even though the value of the property distributed may exceed its cost to the corporation.
   


20. I.R.C. § 311(b) (1982) (repealed 1986). In determining the amount of gain, the value of the inventory distributed was compared with the value of the inventory as if it were valued "under a method authorized by section 471." Id. § 311(b)(1)(A); see also Treas. Reg. § 1.311-1(b)(3) (as amended in 1972). While this method would normally have been FIFO, the statutory language suggested some latitude. If the LIFO value of the inventory was $5,000 and the FIFO value was $9,000, $4,000 of gain would have been recognized.
ject to a liability, or the shareholders assumed a liability of the corporation in connection with the distribution, and the liability exceeded the corporation’s basis in the asset, the corporation would have recognized gain. 21

As originally enacted, section 336 was the true codification of the General Utilities doctrine. Under that section and subject to the judicial exceptions discussed below, a liquidating corporation could distribute any asset other than an installment receivable without recognizing gain at the corporate level. 22 Unlike section 311, there was no requirement in section 336 that a corporation recognize gain or loss on a liquidating distribution of LIFO inventory or property subject to a liability. Section 336 was amended by the Crude Oil Windfall Profit Tax Act of 1980 23 to subject LIFO inventory to a corporate level tax in a liquidation plan adopted after December 31, 1981.

Section 336 provided the same treatment for partial liquidations as for complete liquidations. 24 As long as the distribution qualified as a partial liquidation under section 346, no gain or loss was recognized at the corporate level except with respect to distributions of installment notes. 25

In enacting the 1954 Code, Congress somewhat broadened the General Utilities doctrine. Section 337 of the 1954 Code, otherwise known as the “Anti-Court Holding Company Provision” 26 provided that a corporation could adopt a plan of liquidation, sell its property, and distribute cash proceeds to its shareholders without recognizing gain at the corporate level, as long as the liquidation was completed within a twelve month period. Section 337 covered sales of inventory after the adoption of a plan as long as the inventory was sold in a single bulk sale. Gain was recognized in the case of sales by a collapsible corporation and where the shareholders elected the carry-over basis provisions of section 333. 27

21. I.R.C. § 311(c) (1982) (amended 1986). Where the shareholder took subject to, but did not assume a liability, gain was the lesser of (i) the liability less the basis, or (ii) the fair market value less the basis. Where the debt was assumed, the gain was the difference between the liability and the adjusted basis. Id.


25. Id.

26. I.R.C. § 337 (1982) (repealed 1986) was adopted to eliminate the step-transaction problem of Commissioner v. Court Holding Co., 324 U.S. 331 (1945) and its progeny. See S. Rep. No. 1622, 83d Cong., 1st Sess. 258, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4896. In Court Holding Co., a corporation withdrew from its oral agreement to sell its only asset and instead distributed the asset to its shareholders in liquidation. 324 U.S. at 333. The shareholders then sold the asset to a third party. Id. The Supreme Court looked to the substance of the transaction over its form and held that the substance of the transaction was a sale by the corporation to the third party and that substance prevailed over form. Id. at 334.

III. OTHER STATUTORY AND JUDICIAL EXCEPTIONS

While the significance of the judicial and statutory exceptions to sections 311 and 336 is diminishing, such exceptions are still of crucial importance to those distributions which are covered by the transitional rules to the amendments to sections 311 and 336 made by the TRA '86. These transitional rules are discussed in detail in part IV below.

A. Statutory Exceptions

Congress has passed several exceptions to the general rule of nonrecognition since the original enactment of sections 311 and 336 so as to eliminate what it perceived as abusive transactions.

1. Recapture of Depreciation and Investment Credit

The depreciation and investment credit recapture rules overrode the general rules of nonrecognition of sections 311 and 336. Consequently, a distribution of section 1245 property resulted in the recognition of ordinary income to the corporation in an amount equal to the lesser of (i) the fair market value minus the adjusted basis, or (ii) the post-1961 depreciation deductions taken on the property. Similarly, distributions of real property generated ordinary income to the extent that the lesser of the fair market value or excess depreciation deductions (accelerated depreciation minus straight line depreciation) exceeded adjusted basis. In addition, section 291(a) caused a portion of the nonexcess depreciation portion of a distribution of section 1250 property to be recaptured as ordinary income. Finally, distributions of property, on which an investment tax credit was taken prior to the close of the useful life which was taken into account in computing the credit, constituted an early disposition which triggered recapture.

28. Unless otherwise indicated, all Code section references in Part III of the text are to the Internal Revenue Code of 1954, as in effect immediately prior to the enactment of the Internal Revenue Code of 1986.

29. TRA'86, supra note 3, § 633.


33. Id. § 1250(a).


2. Collapsible Corporations

The rules regarding collapsible corporations enacted as part of the 1954 Code also overrode sections 311 and 336. Under section 341(f) a corporation could have consented to recognize gain on a disposition of assets that otherwise would have been nontaxable, thus protecting a shareholder who wished to dispose of his stock from incurring ordinary income as opposed to capital gain taxation on such a sale.

3. Subchapter S Corporations and Foreign Corporations

Pursuant to section 1363(d), a subchapter S corporation recognized gain on any non-liquidating distribution of appreciated property. Since the shareholders took such property with a step up in basis, it was appropriate to impose the tax at the time of the distribution. The gain which was recognized by the corporation was reduced by any corporate level tax imposed by section 1374. Such gain flowed through to the shareholders under the general rules of section 1366.

Under the Foreign Investment Real Property Tax Act of 1980 a foreign corporation is taxable when it distributes an interest in United States situated real property.

4. Redemptions and Dividends

The Tax Reform Act of 1969 further restricted the general rule of nonrecognition by the addition of section 311(d) which required recognition of gain (but not loss) to a corporation which distributed property in redemption of stock. Section 311(d)(2), however, provided for numerous exceptions under which a redemption would qualify for nonrecognition. Congress repeatedly amended, repealed and added to these

36. See id. § 341(f).
37. Thus, if a greater than five percent shareholder disposed of his stock within six months of the corporation's consent under § 341(f), and subsequently the corporation distributed appreciated property, the general rules of nonrecognition under §§ 311 and 336 would not have applied. Id. § 341(f). See generally BITTKER & EUSTICE, supra note 11, at ¶ 12.08; Ginsburg, Collapsible Corporations—Revisiting an Old Misfortune, 33 TAX L. REV. 309 (1978).
39. I.R.C. §§ 301(d), 1363(d).
41. See generally Starr, 60-7th Tax Mgmt. (BNA) (1986), S Corporations.
46. Section 311(d)(2) provided nonrecognition of: (1) distributions in complete termination (repealed in 1982); (2) distributions of corporate stock or obligations (repealed in 1982); (3) distributions pursuant to an antitrust decree (repealed in 1982); (4) distributions to pay death taxes under section 303(a) (repealed in 1986); (5) dis-
exceptions. With the TRA'86 Congress eliminated all exceptions, thus

tributions to a private foundation in a redemption of stock described in section 537(b)(2) (repealed in 1986); (6) a redemption by a regulated investment company upon demand of the shareholder (repealed in 1986); and (7) distributions effected pursuant to the Bank Holding Company Act under sections 1101(a)(1) or 1101(b)(1) of the Code (repealed in 1982).

47. TEFRA substantially altered the provisions of section 311(d). TEFRA repealed four of the prior exceptions, but retained the exceptions for distributions to pay death taxes, distributions to a private foundation in a redemption of stock described in section 537(b)(2), and a redemption by a regulated investment company upon the demand of the shareholder. I.R.C. § 311(d)(2)(D)-(F) (1982) (repealed 1986). More importantly, TEFRA added three new exceptions.

The first exception provided nonrecognition treatment for redemption distributions to corporate shareholders where the distributee took the property with a basis equal to the lesser of its fair market value or its adjusted basis in the hands of the distributor. Id. § 311(d)(2)(A) (1982) (repealed 1986). This exception was more permissive than any of the previous exceptions. Compare I.R.C. § 311(d)(2) (1954) (as originally enacted) with id. § 311(d)(2)(A) (1982).

The second new exception provided by TEFRA applied where a redemption distribution was made with respect to qualified stock pursuant to a partial liquidation under section 302(b)(4). I.R.C. § 311(d)(2)(B) (1982) (repealed 1986). Qualified stock was defined as:

stock held by a person (other than a corporation) who at all times during the lesser of (i) the 5-year period ending on the date of distribution, or (ii) the period during which the distributing corporation (or a predecessor corporation) was in existence, held at least 10 percent in value of the outstanding stock of the distributing corporation (or predecessor corporation). I.R.C. § 311(e)(1) (1954) (as amended 1982).

Finally, TEFRA provided a new exception which allowed for nonrecognition treatment where a corporation distributed stock or obligations of a controlled corporation if: (i) the distribution was made with respect to qualified stock; (ii) no substantial portion of the controlled corporation's non-business assets were obtained from the distributor as a capital contribution or in a section 351 transaction within the five year period ending on the date of the distribution; (iii) more than fifty percent in value of the controlled corporation's stock was distributed; and (iv) substantially all of the controlled corporation's assets consisted of the assets of at least one qualified business. I.R.C. § 311(d)(2)(B) (1982) (repealed 1986).

TRA'84 significantly revised section 311(d) and (e). The primary result of these changes was to subject dividend distributions to taxation at the distributor level and to eliminate the ability of a corporation to distribute appreciated property to a corporate shareholder without the payment of tax at the distributing corporation's level. Under the TRA'84, a corporate taxpayer was required to recognize gains realized from dividend distributions as well as redemption distributions of appreciated property. I.R.C. § 311(d)(3) (1982 as amended 1984) (repealed 1986).

The TRA'84 provided an exception for qualified dividends to non-corporate shareholders. A dividend distribution to a non-corporate shareholder of appreciated property did not result in tax to the distributor if the property was used by the corporation in a qualified trade or business and was not inventory or accounts receivable acquired in the ordinary course of a trade or business for services or inventory assets. Id. § 311(d)(2)(B)(i) (1982 as amended 1984) (repealed 1986).

Similarly, the TRA'84 continued to provide nonrecognition treatment for redemption distributions under section 303 to pay death taxes, redemption distributions to a private foundation, and redemption distributions by a regulated investment company. Id. § 311(d)(2)(C)-(E) (1982) (repealed 1986). The TRA'84 also clarified the definition of qualified stock. Id. § 311(d)(2)(E)(1) (1982 as amended 1984) (repealed 1986). The exception for redemption distributions pursuant to a partial liquidation under section 302(b)(4) also was retained. Id.
requiring recognition of gain on all redemptions and dividends.

5. Partial Liquidations

As originally enacted, section 336 provided nonrecognition treatment at the corporate level for distributions of property in a partial or complete liquidation of a corporation. TEFRA amended section 336 to exclude partial liquidations, thus providing nonrecognition treatment only for a complete liquidation of a corporation. TEFRA added a new paragraph (4) to section 302(b), however, to provide that a redemption of

§ 311(d)(2)(A)(i) (1982 as amended 1984) (repealed 1986). The TRA'84 repealed the former exception relating to redemption distributions to corporate shareholders, rendering it virtually impossible for one corporation to distribute appreciated property as a dividend to another corporation under section 311 without paying tax on that appreciation. Id. § 311(d)(2)(A) (1982) (repealed 1984). Finally, the TRA'84 provided that the nonrecognition rules of section 311(d) come into play after the application of the LIFO and liability in excess of basis rules. Id. § 311(d)(1) (1982 as amended 1984) (repealed 1986).

Essentially, the nonrecognition of gain rule of section 311(a) had been completely subsumed by the general recognition rule of section 311(d). Thus, only the transactions described in section 311(d)(2) and liquidations pursuant to section 336 qualified for nonrecognition treatment.

48. A partial liquidation was defined in § 346 (as originally enacted) as (i) one of a series of distributions in redemption of all of the stock of a corporation pursuant to a plan of liquidation, or (ii) a distribution which is not essentially equivalent to a dividend in redemption of part of the stock of a corporation pursuant to a plan of liquidation and occurring within the taxable year in which the plan is adopted or within the succeeding taxable year and which meets the requirements of § 346(b). That section provided that the assets distributed must consist of a trade or business which was actively conducted throughout the five-year period ending on the date of the distribution and such trade or business was not acquired by the corporation within the five-year period in a transaction in which gain or loss was recognized in whole or in part. In addition, the distributing corporation was required to be actively engaged in the conduct of a trade or business which was actively conducted throughout the five-year period ending on the date of the distribution and which was not acquired by the corporation during such period in a transaction in which gain or loss was recognized in whole or in part. Accordingly, a corporation could only satisfy the requirements of a partial liquidation if it carried on two or more active trades or businesses which it had conducted for at least five years and which it did not acquire in a taxable transaction within such period.

49. After amendment by TEFRA, section 302(e) read as follows:

(e) Partial Liquidation Defined. —

(1) In general. — For purposes of subsection (b)(4), a distribution shall be treated as a partial liquidation of a corporation if

(A) the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level), and

(B) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

(2) Termination of business. — The distributions which meet the requirements of paragraph (1)(A) shall include (but shall not be limited to) a distribution which meets the requirements of subparagraphs (A) and (B) of this paragraph:

(A) The distribution is attributable to the distributing corpora-
stock from a noncorporate shareholder in partial liquidation of the corporation would be treated as an exchange. A distribution would qualify as a partial liquidation if it (i) was not essentially equivalent to a dividend, (ii) was made pursuant to a plan, and (iii) occurred within the taxable year in which the plan was adopted or within the succeeding taxable year.50

The effect of these amendments was to permit nonrecognition treatment in a partial liquidation only if the shareholders receiving assets were not corporate shareholders.51 The rationale for this change was to prevent corporations from acquiring other corporations and selectively stepping-up the basis of the acquired company's assets at little or no tax cost through the use of the partial liquidation provisions.52
B. Holding Period of Appreciated Property Distributed to a Corporation

Prior to the TRA'84, when a corporation distributed appreciated property in redemption of a corporate shareholder and the distributor did not recognize gain pursuant to section 311(d)(2)(A), the distributee's holding period included the period of time the property was held by the distributor.\(^{53}\) Section 301(e), enacted by the TRA'84, provided different rules regarding the distributee's holding period. Where gain was recognized to the distributing corporation under section 311(d), the distributee's holding period began on the date of the distribution.\(^{54}\) Conversely, where gain was not recognized under section 311(d), the distributee's holding period included the period of time the property was held by the distributor but did not include any period of time prior to the date on which the distributee purchased the distributing corporation's stock.\(^{55}\)

Section 301(e) did not apply to distributions in complete liquidation of a corporation.\(^{56}\) In general, a liquidation is a taxable event with respect to the shareholders. Accordingly, the shareholders would start a new holding period for any property received in a liquidation.\(^{57}\) Where the shareholders elected to obtain a carry over basis in the distributed property, however, the holding period included the period during which the shareholder held the stock surrendered in the complete liquidation.\(^{58}\) Similarly, in a liquidation of a subsidiary pursuant to section 332, the parent corporation took the property with the subsidiary's holding period.\(^{59}\) In a section 332 liquidation, any minority shareholder had a taxable transaction and thus, began a new holding period for any property received.

C. Judicial Exceptions

The courts were quick to interpose limitations on the availability of the General Utilities rule of nonrecognition.\(^{60}\) The all-purpose step transaction doctrine, as well as the business purpose doctrine, have been consistent weapons denying taxpayers nonrecognition treatment. In addition, the courts accept the Commissioner's arguments that the tax benefit rule and attribution of income principles apply in General Utilities

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\(^{54}\) Id. § 301(e)(1) (West Supp. 1988).
\(^{56}\) See I.R.C. § 331(b) (West Supp. 1988).
\(^{60}\) See, e.g., BITTKER & EUSTICE, supra note 15, ¶7.21; Loengard & Cobb, Who Sold the Bush Brothers' Beans?: The Commissioner's Power to Ignore the Transfer of an Asset Prior to Sale, 35 TAX L. REV. 509 (1980).
situations. While development of all of these exceptions predates the original enactment of sections 311 and 336, their import has survived the legislative action. Indeed, Congress specifically pointed out that the legislation left intact "existing law with respect to attribution of income of shareholders to their corporation as exemplified in the case of Commissioner v. First State Bank. . . ." While this brief statement left unanswered the question of whether Congress intended to retain all of the judicial exceptions, or merely the attribution of income rules, post-1954 cases demonstrate that the judiciary apparently believes Congress expressed an expansive view of General Utilities.

Under the step transaction doctrine, the courts treat a series of transactions as one transaction if the series of steps are so interrelated that one step would not be taken without the succeeding steps. A distribution of assets by a corporation followed by an immediate sale of the distributed assets by the shareholders to a third party pursuant to a plan previously negotiated by the corporation has been treated by the courts as a sale of the assets by the corporation with gain recognition at the corporate level and a dividend or liquidating distribution of cash to the shareholders.

In determining whether the step transaction doctrine applies, the critical factors to be considered are (i) which party negotiated the sale of assets and (ii) whether an immediate sale was anticipated. As long as the shareholders and the corporation carefully avoid the corporation's participation in the sale, avoidance of the step transaction doctrine is possible.

The judiciary also developed a business purpose doctrine with respect to corporate distributions of appreciated property. This doctrine, however, is articulated less clearly and is relied upon less often than the step transaction doctrine. Under the business purpose doctrine, if a distribution of appreciated property was motivated primarily by a tax avoidance purpose rather than by a legitimate business purpose, the distribution is treated as a constructive sale by the corporation.

As noted above, the attribution of income concept, provided in

64. See Hines v. United States, 477 F.2d 1063 (5th Cir. 1973); Waltham Netoco Theaters, Inc. v. Commissioner, 401 F.2d 333 (1st Cir. 1968); United States v. Lynch, 192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952); Master Eagle Ass'n, Inc. v. United States, 508 F. Supp. 129 (S.D.N.Y. 1981); BITTKER & EUSTICE, supra note 15, ¶11.63.
66. See supra note 61 and accompanying text.
Commissioner v. First State Bank, 67 survived the enactment of section 311 and requires a corporation to recognize income with respect to receivables distributed to its shareholders. 68

The Supreme Court has also held that the tax benefit rule overrides nonrecognition under sections 311 and 336. Consequently, where a corporation has obtained a deduction with respect to an item (such as depreciated property) and distributes the item to the shareholders, the deduction will be recaptured. 69

IV. DISTRIBUTIONS AFTER THE TAX REFORM ACT OF 1986 70

A. Non-Liquidating Distributions by Regular Corporations

The TRA'86 repealed the General Utilities doctrine by making various amendments to subchapters C and S of the Code. While section 311(a) still encompasses the general rule that a corporation does not recognize any gain or loss on the distribution of property with respect to its stock, section 311(b) provides that a corporation will recognize gain if it distributes appreciated property (other than an obligation of the corporation) to a shareholder as a dividend or in redemption of such shareholder's stock. 71 For purposes of section 311(a), a distribution of property which is subject to a liability will be deemed to have a fair mar-

67. 168 F.2d 1004 (5th Cir.), cert. denied, 335 U.S. 867 (1948).
70. Unless otherwise indicated, all code section references in part IV of text are to the Internal Revenue Code of 1986, as amended.
71. After amendment by the TRA'86 § 311 reads as follows:

Taxability of corporation on distribution.

(a) General rule. — Except as provided in subsection (b), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of —
(1) its stock (or rights to acquire its stock), or
(2) property.

(b) Distributions of appreciated property. —
(1) In general. — If —
(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and
(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),
then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(2) Treatment of liabilities in excess of basis. — Rules similar to the rules of section 336(b) shall apply for the purposes of this subsection.

ket value which is not less than the amount of such liability. It is impor-
tant to note that under section 311, a distribution of property with a
fair market value which is less than the adjusted basis of such property in
the hands of the corporation does not result in the recognition of loss by
the corporation.

Section 311, as amended by the TRA'86, applies to all nonliquidat-
ing distributions made after December 31, 1986.73

B. Liquidating Distributions by Regular Corporations

Sections 336 and 337 as in effect prior to the TRA'86 were repealed
and new sections 336 and 337 were enacted by section 631 of the
TRA'86.74

The general rule of new section 336 is that gain or loss is recognized
by a corporation on the distribution of property in complete liquidation
of the corporation. Where a corporation distributes property which is
subject to a liability, or the shareholder assumes a liability of a liquidat-
ing corporation in connection with the distribution, the property is
deemed to have a fair market value not less than the amount of the
liability.76

The new law provides two basic exceptions to the general rule of
taxability. Section 336(c) provides that the general rule of recognition
will not apply to any distribution of property to the extent that the recipi-
et does not recognize gain or loss with respect to such property under
the reorganization provisions of the Code. Accordingly, a distribution of
stock (other than boot) under a plan of reorganization will not trigger
corporate level gain. Similarly, section 337(a) provides that a liquidating
 corporation will not recognize gain with respect to property distributed
to its parent corporation in a subsidiary liquidation pursuant to section
332.77 Distributions to a minority shareholder in a section 332 liquidat-

72. Id. § 311(b)(2) (West Supp. 1988); see supra note 71.
73. TRA'86, supra note 3, § 633.
74. Id. § 631.
75. I.R.C. § 336(a) (West Supp. 1988) provides:

Gain or loss recognized on property distributed in complete liquidation.

(a) General rule. — Except as otherwise provided in this section or
section 337, gain or loss shall be recognized to a liquidating corporation on
the distribution of property in complete liquidation as if such property
were sold to the distributee at its fair market value.

76. I.R.C. § 336(b) (1986) provides:

Treatment of liabilities in excess of basis. — If any property distributed in
the liquidation is subject to a liability or the shareholder assumes a liability
of the liquidating corporation in connection with the distribution, for pur-
poses of subsection (a) and section 337, the fair market value of such prop-
erty shall be treated as not less than the amount of such liability.

77. Section 337(a) provides "In General. — No gain or loss shall be recognized to the
liquidating corporation on the distribution to the 80-percent distributee of any
property in a complete liquidation to which section 332 applies." I.R.C. § 337(a) (West
section 337(a) does not apply if the parent corporation is a tax exempt organization (other than a cooperative described in section 521). If the distributed property will be used by the tax exempt organization in an unrelated trade or business, however, the nonrecognition provisions will continue to apply. In such a case, a subsequent disposition of the property by the parent or a change in the use of such property to a tax exempt function will result in an increase in the organization's unrelated business taxable income, but not in excess of the amount of gain which was not recognized pursuant to section 337(a).

While the general rule of section 336(a) provides that a corporation will recognize loss on the distribution of assets in a complete liquidation, section 336(d) imposes certain limitations on the recognition of such losses. No loss is recognized by a liquidating corporation if (i) it distributes any property to a related person within the meaning of section 267, and (ii) the distribution is not pro rata or the property is "disqualified property." For these purposes, the term "disqualified property" means any property which the liquidating corporation acquired in a transaction to which section 351 applied, or as a contribution to capital during the five year period ending on the date of the distribution; such term also includes any property the adjusted basis of which is determined (in whole or in part) by reference to the adjusted basis of property acquired in a section 351 transaction or as a contribution to capital.

Example 1: Assume X contributed a building to a corporation in exchange for eighty percent of its stock, and Y contributed cash in exchange for twenty percent of the stock, on March 1, 1988, and the corporation exchanges such building for a new building in a like-kind exchange pursuant to section 1031. The replacement building would constitute disqualified property if it is distributed prior to March 1, 1993. If the building is distributed solely to X prior to such date no loss could be recognized. Conversely, the entire loss could be recognized if the building is distributed solely to Y. Similarly, if the building is distributed pro rata to X and Y, the corporation should be able to recognize twenty percent of the loss.

Section 336(d)(2) limits the ability of a corporation to recognize losses with respect to "built-in" loss property where a corporation acquires property as a contribution to capital or in a section 351 transaction, and the property was acquired pursuant to a plan, a principal purpose of which was the recognition of loss with respect to such property by the liquidating corporation. In such case the corporation's recognized loss is reduced (but not below zero) by the excess of the adjusted

78. Id. § 337(b)(2)(A).
79. Id. § 337(b)(2)(B)(i).
80. Id. § 337(b)(2)(B)(ii).
81. Id. § 336(d)(1)(A).
82. Id. § 336(d)(1)(B).
basis in the property immediately after the acquisition by the corporation over the fair market value of the property at the time of the acquisition.

Any property acquired during the two year period ending on the date of the adoption of the plan of liquidation is deemed to be acquired pursuant to a plan with a principal purpose of recognizing loss by the corporation, unless the acquisition is excepted by regulations to be issued by the Service.\(^{83}\) Notwithstanding this statutory presumption, the legislative history directs the Treasury to ignore the presumption unless there is no "clear and substantial relationship" between the assets and the corporation's current or future business.\(^{84}\)

Example 2: Assume A owns 100% of the stock of X Corporation. X Corporation operates a land development business and holds assets with a fair market value of $1,000,000 and an adjusted basis of $200,000. A contributes to X Corporation securities which have a fair market value of $100,000 and an adjusted basis of $200,000. Within two years after the contribution of the securities X Corporation adopts a plan of liquidation. Presumably, X Corporation would be prevented from offsetting the loss on the securities against the gain on its other assets.

In the above example, if X Corporation had sold the securities and recognized a loss in the year of contribution, and adopted a plan of liquidation in the following taxable year, it is unclear how the rules would operate. If the loss in year one were used against income generated in that year, it would seem that such loss should be permitted, since it does not violate the purposes of section 336(d)\(^{85}\) because the loss is not being

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84. The Conference Committee Report accompanying the TRA’86 states:

The conferees intend that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property two years in advance of the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation’s current or future business enterprises.

[The conferees expect that such regulations would permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation. In such circumstance, application of the loss disallowance rule is inappropriate assuming there is a meaningful relationship between the contribution and the utilization of the corporate form to conduct a business enterprise, i.e., the contributed business, as distinguished from a portion of its assets, is not disposed of immediately after the contribution. (Emphasis in original).

H.R. REP. No. 841, 99th Cong., 2d Sess. II-201 (1986) [hereinafter the CONF. COMM. RPT.].

85. If the loss assets are sold shortly after they are contributed to the corporation, the Service could attempt to attribute such loss to the contributing shareholder pursuant to the step transaction doctrine or I.R.C. § 482 (1982). See National Sec. Corp. v. Commissioner, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); see also Court Holding Co. v. United States, 324 U.S. 321 (1945).
used to offset gain arising from a liquidation. To the extent the loss is carried over to the year of liquidation and is used to offset gain arising from the liquidation, however, it would seem that the statute mandates that such loss be disallowed. Those results would be consistent with the congressional intent that losses from the disposition of the assets of a trade or business would not be subject to the presumed prohibited purpose rule. The legislative history clearly contemplates that where assets of a trade or business are contributed to a corporation, the regulations will not disallow a loss on an ordinary disposition of all of the assets of such trade or business.

The language in the Conference Committee Report is quite broad and covers existing, as well as new, business enterprises. For example, assume the same facts as in the previous example except that, instead of contributing securities to X Corporation, A contributes all of the assets of a manufacturing business. Again, those assets have a fair market value of $100,000 and an adjusted basis of $200,000. Even though X Corporation has not been engaged in the manufacturing business prior to contribution of such assets, the $100,000 loss resulting from the disposition of the entire line of business should not ordinarily be disallowed. As a matter of policy, such losses should only be disallowed if at the time such assets were contributed there was a binding commitment to both (i) dispose of the assets and (ii) adopt a plan of liquidation.

The regulations should adopt a \textit{de minimis} exception for reasons of administrative convenience. Where the built-in loss is small relative to the value of the corporation or the inherent gain in the corporation's assets, the likelihood that such assets were contributed for a prohibited purpose is small. Conversely, where the built-in loss is significant relative to the inherent gain, the regulations are unlikely to provide for an exception.\textsuperscript{86}

The regulations should also exempt any losses which result from assets which were contributed to a corporation during its first two years of existence.\textsuperscript{87} Similarly, contributions of built-in loss property which predate a plan of liquidation by more than two years should be disallowed only if there is an extraordinary link between the contribution and the plan of liquidation, such as binding commitments to both (i) sell the assets and (ii) adopt a plan of liquidation.\textsuperscript{88}

The disallowance of losses pursuant to section 336(d)(2) should not extend to losses accruing after the property is contributed to the corpora-

\textsuperscript{86} See \textit{CONF. COMM. RPT.}, supra note 84, at II-201.

\textsuperscript{87} \textit{Id.} Such a result was obviously intended by Congress in that the Conference Committee Report states: "The conferees also anticipate that the basis adjustment rules will generally not apply to a corporation's acquisition of property during its first two years of existence." \textit{Id.}

\textsuperscript{88} \textit{Id.} at II-200. As stated in the Conference Committee Report: "Although a contribution more than two years before the adoption of a plan of liquidation might be made with a prohibited purpose, the conferees expect that those rules will apply only in the most rare and unusual cases under such circumstances." \textit{Id.}
tion. For example, if A contributes to a corporation property with a fair market value of $100,000 and an adjusted basis of $200,000 on the date of contribution, and prior to the disposition of the assets the property declines in value to $60,000, the corporation should be permitted to use $40,000 of the total $140,000 loss. If the loss in the above example would be disallowed under both provisions, section 336(d)(1) would operate to disallow the entire loss, not just the loss which accrued prior to the date of contribution.

The Secretary of the Treasury is authorized to promulgate regulations to allow or require a taxpayer to recapture, in the year of liquidation, a loss which was taken in a preceding tax year and which was attributable to property contributed for a prohibited purpose, in lieu of amending the return for the year in which such a loss was taken to recognize additional income. It is unclear what Congress intended by enacting this provision. One possibility is that Congress was concerned that such regulations might be necessary to prevent taxpayers from circumventing the loss disallowance rules of section 336(d). In light of the broad grant of regulatory authority under subparagraph (2)(B)(ii), it appears more likely that Congress enacted subparagraph (2)(C) to afford taxpayers a marginal degree of relief from the strict disallowance rules. Specifically, from the taxpayer's perspective, the ability to recognize a tax benefit of utilizing a loss in a prior year and recapturing such tax benefit in a subsequent year is preferable to a complete disallowance of the use of the loss. Such an interpretation of subparagraph (2)(C) would be consistent with, and lends support to, the notion that the regulations promulgated pursuant to subparagraph (2)(B)(ii) should not ordinarily disallow the use of a loss generated by built-in loss property against non-liquidating income.

A third limitation on the use of losses arising in a liquidation is provided by section 336(d)(3), whereby a corporation is not permitted to recognize any loss on property distributed in connection with a liquidation to which section 332 applies (i.e., a subsidiary liquidation). Consequently, while a corporation which liquidates under section 332 must recognize gain with respect to distributions to minority shareholders, such a corporation is not permitted to recognize loss with respect to such distributions.

The House of Representatives' version of the TRA'86 would have resulted in confiscatory multiple taxation of sales to group members or third parties and distributions of stock in a multi-tiered consolidated group. To avoid this multiple taxation the Conference Committee ad-


90. Id.


ded section 336(e) which provides that the Secretary of the Treasury may issue regulations which would permit a corporation to treat the sale or distribution of stock of another member of the consolidated group as a sale or disposition of the underlying assets as long as the “corporation sells, exchanges, or distributes all of such stock.”93 The provision was designed to be consistent with the election available under section 338(h)(10).94 Presumably, the statutory language is to be read as a sale, exchange, or distribution of all of the stock of the subsidiary which is owned by the members of the consolidated group.

Finally, section 337(d) grants the Secretary of the Treasury broad authority to promulgate regulations preventing the “circumvention” of the repeal of the General Utilities doctrine.

C. Distributions by Subchapter “S” Corporations

Prior to the TRA’86 section 1374 imposed, in certain situations, a corporate level tax on a subchapter S corporation which was formerly a subchapter C corporation. Where a C corporation elected to be taxed as an S corporation prior to January 1, 1987, and during any of the first three tax years after the subchapter S election is effective the corporation has a net capital gain in excess of $25,000 and in excess of 50% of its taxable income, a corporate level tax is imposed on such gain.95 Essentially the same treatment is given to a C corporation which makes an S election after December 31, 1986, and prior to January 1, 1989, and which would otherwise qualify for the small corporation transitional rule to the repeal of former sections 336 and 337.96 In such a case, however, if the corporation has a value in excess of $5,000,000 and it recognizes gain on sales of built-in gain property within ten years of the date the S election becomes effective, a portion of the built-in gain will be taxable at both the corporate level and the shareholder level under section 1374 as amended by the TRA’86.97 In addition, short term capital gain and ordinary income which is built-in gain are taxable under new section 1374. Finally, all other capital gains recognized during the three-year period beginning on the date the S election is effective are subject to possible taxation at the corporate level under former section 1374.98

A C corporation which makes an S election after December 31, 1986, and which is not covered by the small corporation transitional rule, is fully subject to new section 1374 enacted to eliminate an end run around the repeal of General Utilities.99 Section 1374 provides that a tax

95. See I.R.C. § 1374 (1982) (prior to amendment by TRA’86, supra note 3, § 632(a)).
96. See TRA’86, supra note 3, § 633(d)(8); see also infra notes 123-44 and accompanying text.
98. See General Explanation 1986, supra note 83, at 353.
99. In the absence of the new I.R.C. § 1374 (West Supp. 1988), a corporation could
will be imposed at the corporate level at the highest applicable rate if property, which has a built-in gain, is sold in any of the first ten years during which such corporation is taxed as an S corporation.\footnote{100} Section 1374(d)(1) defines built-in gain as the fair market value of the assets of the corporation at the beginning of its first taxable year as an S corporation over the aggregate adjusted basis of the assets at that time. The taxpayer bears the burden of proving that gain on the sale of an asset is not built-in gain.\footnote{101} Accordingly, a corporate level tax will be imposed on any gain with respect to dispositions of any asset during the ten-year period unless the corporation can establish that the asset was not held by the corporation at the time the S election became effective or such gain exceeds the built-in gain on the effective date of the S election.\footnote{102} Corporate level taxes arising under new section 1374 may be offset by net operating loss carry forwards from a period in which the corporation was a C corporation.\footnote{103} Similarly, business credit carryovers arising from a taxable year in which the corporation was a C corporation may offset such tax.\footnote{104}

The Technical Corrections Bill of 1987\footnote{105} provides that built-in gain includes gain on any asset acquired by an S corporation from a C corporation in a carryover basis transaction.\footnote{106}

Example 3: Assume C Corporation is a subchapter C corporation which holds a building with a fair market value of $500,000 and an adjusted basis of $100,000. C Corporation merges into S Corporation which is, and always has been, an S corporation. S Corporation is the surviving entity in the merger. If S Corporation disposes of the building within ten taxable years after the merger, a corporate level tax would be imposed on the $400,000 of built-in gain.

**D. Rules Affecting Regulated Investment Companies and Real Estate Investment Trusts**

The TRA'86 did not specifically enact rules relating to distributions by pass-through entities such as a regulated investment company ("RIC") or a real estate investment trust ("REIT") such as those contained in section 1374 with respect to subchapter S corporations. Furthermore, there was nothing in the legislative history of the TRA'86 which would have alerted taxpayers to the possibility that a subchapter C
corporation which acquires the status of a RIC or a REIT through an election\textsuperscript{107} or a merger, could be subject to a corporate level tax on the appreciation of its assets, either (i) at the time of the election or merger, or (ii) when the assets are sold. Nevertheless, that appears to be the result which is developing.

As noted above, section 337(d) authorizes the Secretary of the Treasury to promulgate:

\begin{quote}
such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to this subpart by the Tax Reform Act of 1986, including -
\begin{enumerate}
\item Regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter). \ldots \textsuperscript{108}
\end{enumerate}
\end{quote}

The Conference Committee Report contains the following explanation of that provision:

The repeal of the \textit{General Utilities} doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or non-liquidating context. The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax free reorganization provisions of the Code (part III of Subchapter C).\textsuperscript{109}

Nevertheless, the Conference Committee Report also clearly states: "Neither gain nor loss is recognized, however, with respect to any distribution of property by a corporation to the extent there is nonrecognition of gain or loss to the recipient under the tax-free reorganization provisions of the code (part III of Subchapter C)."\textsuperscript{110}

Thus, the Conference Committee Report contains an inherent conflict between the scope of the provisions relating to the repeal of the \textit{General Utilities} doctrine and the direction to Treasury to promulgate regulations. More importantly, Congress expressly dealt with pass-

\begin{footnotes}
\item[107] The Code already imposes a toll charge on a corporation which makes an election to be taxed as a RIC or a REIT. I.R.C. § 852(a)(2) (West Supp. 1988), which was added by the TRA'84, \textit{supra} note 34, § 1071(a)(3), requires a corporation which first elects RIC status in a tax year ending on or after November 8, 1983, to distribute all of its accumulated earnings and profits to qualify as a RIC. Similarly, I.R.C. § 857(a)(3) (West Supp. 1988), which was added by § 661(b) of the TRA'86, \textit{supra} note 3, requires a corporation which first elects REIT status in a tax year beginning after February 28, 1986, to distribute all of its accumulated earnings and profits to qualify as a REIT.
\item[109] \textit{CONF. COMM. RPT.}, \textit{supra} note 84, at II-204.
\item[110] \textit{Id.} at II-199 to 200.
\end{footnotes}
through entities in the TRA'86. Section 1374 was enacted to limit the ability of a C corporation to avoid corporate level tax by conversion to an S corporation. The Conference Committee also adopted the Senate version of certain unrelated provisions dealing with REITs, including one which requires a corporation to distribute its accumulated earnings and profits in order to elect REIT status. Congress expressly considered the interplay between the repeal of the General Utilities doctrine and pass-through entities and enacted appropriate and specific statutory safeguards. Thus, the provisions of section 337(d) cannot fairly be read as encompassing a congressional mandate to impose administratively a built-in gain recognition rule on corporations which acquire RIC or REIT status as a result of an election or a reorganization.

Nevertheless, on May 4, 1987, the Joint Committee on Taxation stated in its General Explanation of the Tax Reform Act of 1986 ("General Explanation"):

Congress expected the Treasury Department to issue, or to amend, regulations to ensure that the purpose of the new provisions, (including the new subchapter S built-in gain provisions) is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of subchapter C) or, through the use of other pass-through entities such as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this would include rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate-level tax on the built-in appreciation.

Nothing similar to the emphasized language was found anywhere in the explanation of the House of Representatives’ version of the TRA'86113 or in the Conference Committee Report. The Staff of the Joint Committee seems to have gratuitously expanded the scope of the original provision. Furthermore, the statement in the General Explanation conflicts with the Joint Committee’s own explanation of the reasons for the enactment of Section 337(d). The General Explanation states:

Congress was concerned that taxpayers might use various means (including other provisions of the Code or the Treasury regulations) to circumvent repeal of the [General Utilities] rule or, alternatively, might exploit the provision to realize losses in inappropriate situations or inflate the amount of the losses actually sustained. For example, under the general rule permitting loss recognition on liquidating distributions, taxpayers might be

111. See TRA'86, §§ 661-69; see also supra note 107.
112. GENERAL EXPLANATION 1986, supra note 83, at 345 (emphasis added).
able to create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contributions of property having previously accrued ("built-in") losses. In an effort to prevent these potential abuses, Congress included in the Act regulatory authority to prevent circumvention of the purposes of the amendments through the use of any provision of law or regulations. In addition, it included specific statutory provisions designed to prevent avoidance of tax on corporate level gains through conversions to subchapter S corporation status and unwarranted recognition of losses at the corporate level.114

The Joint Committee also acknowledged that no recognition of gain or loss would take place in the context of a reorganization.115

While acknowledging the scope and the purposes of section 337(d) as explained in the Conference Committee Report, the staff of the Joint Committee, through publication of the General Explanation, has attempted to graft an additional mandate on the Treasury's authority under section 337(d).

Perhaps in recognition of the fact that the statutory language does not support such a mandate, section 106(e)(5) was included in the Technical Corrections Bill. The effect of that amendment is to authorize the Secretary to promulgate regulations imposing a tax on the built-in gain of a regular corporation which acquires RIC or REIT status through an election or a reorganization.116 Moreover, such amendment is apparently retroactive to the original enactment date of the TRA’86. Consequently, the Secretary could adopt regulations which impose such a tax on transactions which occurred prior to the publication of the General Explanation or the introduction of the Technical Corrections Bill. Notwithstanding the Joint Committee's position that section 106(e)(5) of the Technical Corrections Bill is a technical clarification, as opposed to a substantive change, the Service issued a private letter ruling in April, 1987 which held that a C reorganization between a personal holding company and a RIC qualified as a tax-free reorganization under the Code.117 There was no indication that a tax might be imposed on the built-in gain pursuant to the regulations to be promulgated under section 337(d) of the Code.

Neither the TRA’86 nor the Technical Corrections Bill provides any specific guidance regarding the nature of regulations governing the election of RIC or REIT status by a subchapter C corporation or the merger of a RIC or a REIT with a subchapter C corporation. One position for the regulations to take is that a corporation which acquires RIC or REIT status recognizes gain at the time of such election or merger equal to its

114. GENERAL EXPLANATION 1986, supra note 83, at 337.
115. Id. at 340-41.
116. See DESCR. OF TECH. CORR. BILL, supra note 89, at 48.
built-in gain.\textsuperscript{118} Alternatively, the regulations may provide a rule similar to the statutory rule of section 1374, under which the RIC or REIT would recognize gain only as and when it sold built-in gain assets during the ten-year period following the election or the merger.

If the regulations adopt an administrative version of section 1374, a RIC or REIT could find itself in the following catch-22 situation: Assume X corporation (a subchapter C corporation) owns a diversified portfolio of stock with a fair market value of $1,000,000 and an adjusted basis of $100,000. X merges into M corporation (a RIC). Prior to the expiration of the ten-year period, M sells the assets for $1,000,000. Under the regulations, M would be required to pay a corporate level tax of approximately $300,000 on the $900,000 built-in gain. However, M would normally distribute the entire $900,000 gain pursuant to section 852(b)(3). Since M must use $300,000 of the sale proceeds to pay a corporate level tax, there is only $700,000 left to distribute to its shareholders. Accordingly, it cannot satisfy the capital gain distribution requirement of section 852(b).\textsuperscript{119} In the absence of a statutory amendment to the definition of the corporation's capital gain, the only option for M would be to pay the shareholder level tax and pass through a tax credit to its shareholders pursuant to section 852(b)(3)(D).\textsuperscript{120} The nature of RICs (and REITs), however, is such that very few of them pass through capital gain credits.

Another solution to the problem would be for a portion of the M stock which was transferred to the X shareholders at the time of the merger to be escrowed and used by the corporation to pay the built-in gain tax liability. However, since the stock would have to be escrowed for a period of at least ten years, such an escrow arrangement would violate the Service's ruling guidelines on escrowed stock arrangements in reorganizations.\textsuperscript{121}

Another alternative would be for the regulations promulgated by the Secretary to permit RICs and REITs to elect whether to (i) pay the tax at the time of the reorganization or election on all of the built-in gain, or (ii) subject themselves to the administrative version of section 1374. Treasury Regulations redefining capital gain under sections 852(b) and 857(b) would seem to be outside of the Service's regulatory authority.

The grant of regulatory authority under section 337(d) to promulgate regulations imposing a tax on investment company mergers seems to conflict directly with section 336(c) which provides that no tax is imposed at the corporate level with respect to a distribution which is not subject to tax by the recipient pursuant to the reorganization provisions. As a matter of statutory construction, the specific rule should override

\textsuperscript{118} The Regulations should exempt corporations which would qualify for the small corporation transitional rule described in infra notes 123-44 and accompanying text.
\textsuperscript{119} A REIT would face the same problem under § 857(b).
\textsuperscript{120} A REIT would face the same problem under § 857(b)(3).
the more general grant of regulatory authority. Furthermore, investment company mergers are already subject to stringent requirements regarding diversification to qualify as tax-free reorganizations.\(^{122}\)

As a matter of tax purity, the result obtained under the Joint Committee's reading of section 337(d) and the amendments proposed by the Technical Corrections Bill are justified. Such regulations would obviously close a hole in the net of the repeal of the General Utilities doctrine. Such a result, however, does not make sense from a tax policy standpoint. Because of the peculiar nature of subchapter C corporation investment companies (which are most often personal holding companies) and the market forces driving RICs and REITs, it appears that the Treasury actually loses money by imposing a corporate level tax on such an election or merger. The Appendix to this article contains a computer model comparing the tax which would be paid by a personal holding company and its shareholders with the tax which would be paid by the shareholders of a RIC on the same portfolio of assets. A personal holding company does not turn over its portfolio very frequently because its capital gains are subject to tax at the corporate level when realized and at the shareholder level when distributed. Conversely, a RIC is market driven to generate cash distributions to its shareholders. Accordingly, RICs have very high turn-over rates.

As demonstrated in the model, in year one, the personal holding company would generate a corporate and shareholder tax totalling $3,910,973 while the RIC would generate a shareholder level tax of $17,022,486. In each of the next twenty years the tax generated by the RIC significantly exceeds the total corporate and shareholder level tax generated by the personal holding company. Over twenty years the total tax generated by the personal holding company is $147,121,511 while the total tax generated by the RIC is $258,439,719.

E. Transitional Rules

The TRA'86 included a number of transitional rules designed to soften the immediate impact of the repeal of the General Utilities doctrine. Subject to the exceptions noted below, a grandfathered transaction is subject to the provisions of subchapter C of the Code as in effect prior to the TRA'86 and the corresponding judicial doctrines. Nevertheless, a liquidation completed after December 31, 1986 under the transitional rules could cause an alternative minimum tax problem for the liquidating corporation because the Service takes the position that unrecognized gain from a section 337 sale is included in book income for corporate tax preference purposes.\(^{123}\)


1. General Effective Date.

The general effective date for amendments to sections 311, 336, and 337 is January 1, 1987. Section 633(a)(1) of the TRA'86 provides that the provisions of former sections 336 and 337 apply to any liquidation completed prior to January 1, 1987. Similarly, TRA'86 section 633(a)(3) provides that the provisions of former section 311 apply to any non-liquidating distribution completed prior to January 1, 1987:

2. Binding Contract and Written Plan Transition Rules

Former sections 336 and 337 also apply in the case of certain plans of liquidation and binding contracts. The transactions which are covered include: (i) any distribution or sale or exchange pursuant to a plan of liquidation adopted before August 1, 1986 as long as the corporation is completely liquidated before January 1, 1988;\textsuperscript{124} (ii) any distribution, sale, or exchange made by a corporation where 50\% or more of the voting stock (by value) of such corporation is acquired on or after August 1, 1986 pursuant to a written binding contract which was in effect on August 1, 1986, and if the corporation is completely liquidated prior to January 1, 1988;\textsuperscript{125} and (iii) any distribution, sale, or exchange made by a corporation if substantially all of its assets are sold on or after August 1, 1986 pursuant to one or more written binding contracts in effect prior to that date and if the corporation is liquidated prior to January 1, 1988.\textsuperscript{126}

For the purposes of the preceding three transitional rules, a transaction is treated as pursuant to a plan of liquidation adopted before August 1, 1986 if, prior to November 20, 1985, one of the following conditions is satisfied: (i) the board of directors of the liquidating corporation adopted a resolution to solicit shareholder approval for a liquidation under former sections 336 or 337 or the shareholders or the board of directors approved such a liquidation;\textsuperscript{127} (ii) there was an offer to purchase a majority of the voting stock of the liquidating corporation, or the board of directors of the liquidating corporation adopted a resolution approving an acquisition or recommended the approval of an acquisition to the shareholders;\textsuperscript{128} or (iii) a ruling request was submitted to the Service with respect to liquidation pursuant to former sections 336 or 337.\textsuperscript{129}

3. Small Corporation Transitional Rule

The TRA'86 also provided a transitional rule for certain small corporations. A liquidation of a "qualified corporation" which is completed by January 1, 1989 is governed by former sections 336 and 337 subject to

\textsuperscript{124} TRA'86, supra note 3, § 633(c)(1)(A).
\textsuperscript{125} Id. § 633(c)(1)(B).
\textsuperscript{126} Id. § 633(c)(1)(C).
\textsuperscript{127} Id. § 633(c)(2)(A).
\textsuperscript{128} Id. § 633(c)(2)(B).
\textsuperscript{129} Id. § 633(c)(2)(C).
certain special rules. A corporation which liquidates under the small corporation transition rule will recognize short-term capital gain or loss, and gain or loss which is ordinary gain or loss determined without regard to the amended section 1239. Consequently, a bulk sale of inventory is a taxable transaction, and short-term capital losses must be recognized by a corporation liquidating under this transitional rule. Gain is also recognized to the extent section 453B of the Internal Revenue Code of 1986 applies. Under the literal language of the statute, a distribution of an installment obligation will cause the liquidating corporation to recognize gain even in the case of such a distribution received in exchange for a sale pursuant to a plan of liquidation. Thus, the transitional rule distinguishes between a liquidating sale for cash and a liquidating sale for an installment note. It does not appear that Congress intended such a peculiar result. The Technical Corrections Bill includes a provision which clarifies that a corporation qualifying under the small corporation transition rule does not recognize gain on the distribution of installment notes received in a liquidating sale of assets.

The small corporation transitional rule only applies in full to corporations which have a value of $5,000,000 or less. A corporation with a value in excess of $5,000,000 but less than $10,000,000 will have a ratable portion of its gain or loss recognized under the transitional rule. Example: A corporation which has a value of $6,000,000 would have 20% of its gain or loss recognized; a corporation which has a value of $8,000,000 would have 60% of its gain or loss recognized; and a corporation which has a value of $10,000,000 or more would have all of its gain or loss recognized.

For the purposes of this transitional rule, a corporation’s value is the greater of the fair market value of all of the stock of the corporation on (i) the date of the adoption of the plan of liquidation, or (ii) August 1, 1986.

A corporation is a “qualified corporation” if on August 1, 1986 and at all times thereafter before the corporation is completely liquidated: (i) more than 50% (by value) of the stock of the corporation is held by ten or fewer qualified persons and (ii) the value of such corporation does not exceed $10,000,000. A qualified person means an individual, an estate, or a trust described in section 1361(c)(2)(A)(ii) or (iii). Stock held by a corporation, trust, or partnership is treated as owned proportionally by
its shareholders, beneficiaries, or partners and stock owned or attributed to an individual, his spouse, his children, grandchildren, and parents is treated as owned by a single person for the purposes of meeting the 50% test. In addition, all members of the same controlled group as defined in section 267(f)(1) are treated as a single corporation. Accordingly, an individual or certain groups of individuals who own multiple corporations with an aggregate value of $10,000,000 or more would not qualify for the small corporation transitional rule. Similarly, where a group of corporations has an aggregate value between $5,000,000 and $10,000,000 the liquidation of one of those companies (assuming otherwise qualified under the transitional rule) would result in the recognition of a portion of the gain or loss.

The Conference Committee Report states that one of the requirements to qualify for the small corporation transitional rule is that “more than 50% of [the corporation’s] stock is owned by 10 or fewer individuals who have held their stock for 5 years or longer.” While the statute itself does not include a holding period requirement, the elimination of the language appears to have been inadvertent, and the House of Representatives attempted to restore such language in the enrolling legislation. The enrolling legislation was never passed by Congress; however, the Technical Corrections Bill would amend TRA'86 section 633(d) to restore the holding period requirement.

F. Mirror Transactions and Other Creative Responses to the Repeal of the General Utilities Doctrine

The tax bar has been quick to suggest creative techniques for avoiding corporate level gain as a result of the repeal of the General Utilities doctrine. One such technique is the use of mirror subsidiaries. As discussed below, however, there is substantial controversy as to whether such a transaction will achieve the anticipated results.

Example: Assume T corporation has four assets, each with an adjusted basis of $500 and a fair market value of $2,000. The stock of T is worth $8,000. P corporation desires to acquire some but not all of the assets of T. P forms four subsidiaries (S1, S2, S3, and S4) capitalizing each with $2,000. Each subsidiary purchases one-fourth of T’s stock. T then liquidates pursuant to section 332, distributing one of its assets to each subsidiary. While P would have a basis in the stock of each subsidiary of $2,000, each subsidiary would take a carryover basis of $500 in the asset received. P could then sell the stock of any subsidiary which held unwanted assets for such subsidiary’s fair market value (i.e., $2,000) without recognizing any gain or loss. The linchpin to this technique is

140. Id. at § 633(d)(6)(B).
141. Id. at § 633(d)(6)(C).
142. CONF. COMM. RPT., supra note 84, at II-206.
144. TECH. CORR. BILL, supra note 105, at § 106(g)(6).
the qualification of the liquidation as a section 332 liquidation. Thus, it will work only if the P subsidiaries qualify as 80% distributees under section 337(c). The Conference Committee Report states: "The confer­ ees anticipate that, in a consolidated context, the Treasury Department will consider whether aggregation of ownership rules similar to those in section 1.1502-34 of the Regulations should be provided for purposes of determining status as an 80% distributee."145 Senators Dole and Packwood engaged in a colloquy during the Senate debate of the TRA'86 in which they stated that the mirror subsidiary technique is permitted under the TRA'86 and that it would be inappropriate to alter the treat­ ment of such transactions prior to the completion of Treasury's review of subchapter C.146 In the House debate, however, Chairman Rosten­ kowski stated that the mirror subsidiary technique does not work in the ab­ sence of Treasury regulations.147

Another technique, sometimes referred to as the "son of mirror sub­ sidiary transaction" also relies upon the consolidated return regulations and involves a target corporation in an acquisition adopting a holding company structure. Example: Assume T corporation has three assets with a basis of $100 and a value of $500. T also has a fourth asset with a basis of $300 and a value of $1,000. T contributes each asset to a separate subsidiary (T1, T2, T3, and T4). T's basis in the stock of T1, T2, and T3 is $100 and T's basis in the stock of T4 is $300. P corporation purchases the stock of T for its fair market value of $2,500. If P does not wish to retain the asset held in T4, P could cause T to declare a dividend of the stock of subsidiaries T1, T2, and T3. T would have a gain of $1,200 under section 311. However, such gain would be a deferred intercompany transaction.148 P's basis in the T stock would be reduced to $1,000 by the $1,500 distribution. A sale of the stock of T for its then fair market value of $1,000 would trigger the deferred $1,500 of gain, a corresponding increase in P's basis in the T stock of $1,500, and a result­ ing loss to P on the stock sale of $1,500.

Since the result is identical to a mirror subsidiary transaction, it is unclear whether the controversy surrounding mirror transactions will af­ fect such a transaction. In addition, such a transaction may be affected by an announcement by the Service that it will promulgate regulations denying an investment adjustment in the stock of a subsidiary pursuant to Regulation section 1.1502-32 for transactions after January 6, 1987 which circumvent the repeal of the General Utilities doctrine.149

Another possible end run around the repeal of the General Utilities

145. CONF. COMM. RPT., supra note 84, at II-202 n.9; see also GENERAL EXPLANATION 1986, supra note 83, at 340 n.78.
doctrine in the acquisitions context is the use of a corporate intermediary.

Example: Assume L corporation has a net operating loss carryforward and L acquires the stock of T corporation. L thereafter causes T to sell its assets to another acquiring corporation. Under the consolidated return regulations, L would offset its net operating losses against the gain recognized by T on the sale of its assets and thus, no tax would be paid. At the same time, the acquiring corporation would obtain the assets with a cost basis. Theoretically, the acquiring corporation would be willing to pay a premium for the ability to acquire the assets at a cost basis without incurring a tax liability. Nevertheless, the Service may disregard the transaction under the step-transaction doctrine or under the statutory authority of section 269.

A profit corporation could also act as an intermediary. Example: Assume X corporation purchases the stock of T corporation and causes T to sell its assets to a third corporation. While T would recognize gain on the sale, X would increase its basis in the stock of T by the amount of gain recognized under Regulation section 1.1502-32. If X then sold the stock of T for its fair market value, it would recognize a loss equivalent to the gain recognized in the consolidated return on the sale of the assets.

The viability of such a transaction is questionable in light of the Service's announcement that it will revise Regulation section 1.1502-32 to deny the investment adjustment in the stock of a subsidiary with respect to transactions occurring after January 6, 1987 which circumvent the repeal of the General Utilities doctrine.150

V. CONCLUSION

The TRA '86 completed a long process of whittling away at the General Utilities doctrine. While such a result may be justified as a restoration of the two level tax system, the changes have caused a new set of complexities and uncertainties in the tax system. Many of those uncertainties result from the subjective judgments which must be made in determining how and whether a transaction will be taxed and from the broad delegation of regulatory authority to the Secretary. Until such regulatory authority is exercised and a body of law develops concerning the subjective judgments, the business community will suffer with the vagaries of an uncertain tax system.

150. Id.
## APPENDIX: ANALYSIS AND COMPARISON OF THE TAX REVENUE GENERATED BY A PERSONAL HOLDING COMPANY AND A REGULATED INVESTMENT COMPANY

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The foregoing chart is based upon the following assumptions:

1. Capital gains and ordinary income are taxed at the rate of 34% at the corporate level and 28% at the individual level.

2. The annual turnover rate is 15% for the personal holding company (the "PHC") and 90% for the regulated investment company (the "RIC"). The turnover rate for the PHC is based upon the author's experience representing six such entities holding securities in excess of $125,000,000. The turnover rate for the RIC is based upon the average turnover of 29 mutual funds over the last six years. See Chart 2.

3. The gross yield for the PHC is 4.25% while the gross yield for the RIC is 3% and the expenses are assumed to be 1.25% for the PHC and .9% for the RIC. The appreciation in the portfolio was assumed to be 9% for the PHC and 12.9% for the RIC and the total return is assumed to be 12% for the PHC and 15% for the RIC. The differences in yields and total returns are based upon the differences in investment philosophy between a typical personal holding company and a typical RIC. A personal holding company would ordinarily seek to maximize dividend income at the expense of portfolio appreciation. A RIC would ordinarily seek to maximize appreciation and capital gains distributions. Such decisions are driven, in part, by the tax system. A personal holding company takes advantage of the corporate dividends received deduction and its ability to deduct expenses against corporate income, while capital gains are taxed at the corporate level when realized and again at the shareholder level (at ordinary income rates) when distributed. On the other hand, a RIC passes through all of its income and expenses to the shareholders. The differences in the expenses between the two entities are attributable to the economies of scale.

4. Each entity starts out with $100,000,000 in assets with a basis of $50,000,000.

5. The PHC pays no tax on ordinary income as a result of the dividend received deduction and its deduction of expenses. The shareholders of the RIC obtain no tax benefit for the pass-through of the expenses as a result of the two percent floor on miscellaneous deductions.

6. The amount reinvested in the RIC is deemed to be equal to the amount distributed by the RIC less the shareholder level tax less the distributions (net of tax) which a shareholder of the PHC would have received.

7. The sale value of the PHC is its gross value less corporate level taxes less a 10% brokerage discount. The sale value of the RIC is its net asset value. Also, liquidation values are net of shareholder level capital gains tax.
### Portfolio Turnover Analysis

**CHART 2**

29 Mutual Funds

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The data herein was obtained from the prospectuses of each mutual fund.