Corporate Tax: The Agony and the Ecstasy

William J. Rands
University of Cincinnati, william.rands@uc.edu

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* Professor of Law, University of Cincinnati College of Law. B.A., Centenary College; J.D., Tulane University. I express my thanks to my research assistant, Stephanie Lee, for her help on this article.

1. The Agony and the Ecstasy is a historical novel about Michelangelo. IRVING STONE, THE AGONY AND THE ECSTASY (1961). It was produced in 1965 as a movie starring Charlton Heston. I read the book and watched the movie. I think the ecstasy was Michelangelo turning a block of marble into a statue, but I am not sure. The agony was harder to discern. Perhaps it was Michelangelo being forced to do other kinds of art work, like painting the ceiling of the Sistine Chapel.
I. INTRODUCTION

For many years I have been teaching Corporate Tax to law students. Like most professors, I like to think that I am helping the students by teaching the course. I feel like I am helping them prepare for their careers. Naturally enough, they like to think they will benefit from learning a subject matter that will be of practical use to them. But, of course, humankind does not live on bread alone. Usually, both the students and I enjoy the course. To enjoy a course in a subject matter (and law school for that matter), there needs to be more for the professor than just doing a job and more for the students than just preparing for a job. And, in Corporate Tax, usually there is. Most of us, professors and students, enjoy the challenge of attempting to master, analyze, resolve, apply, and, sometimes, just comprehend complex statutory systems and factual problems. Otherwise, Corporate Tax would be drudgery. For us, it is not. As one corporate tax lawyer says, "corporate tax can be—dare I say it?—fun." Corporate tax law is comprised basically of a group of mini-systems. For example, § 351 and related sections provide a system for incorporations. Section 331 and related sections provide a system for liquidations. Section 368 and related sections provide a system for acquisitions and reorganizations. And so on. Some of these regimes are things of beauty. Once understood, the student can say, "Yes, that makes sense. I like that!" We can call this our "ecstasy." Contrarily, other parts of Corporate Tax leave us shaking our heads and saying, "Congress really ought to be able to do better than that." The rules might not make much sense, or at the very least, be more complex than is really necessary. We can call this our "agony"; although sometimes, we find the complexity almost perversely humorous. For example, referring to the definition of personal holding company income, a leading casebook offers this black humor:

Students of the Internal Revenue Code have come to expect a large degree of complexity when Congress seeks to prevent tax avoidance. Congress must an-

2. I first taught the basic Corporate Tax course in the spring semester of 1979 and have taught it every year since. I added a second course, then called Advanced Corporate Tax in the fall of 1986. In the middle of that semester, Congress adopted the Internal Revenue Code of 1986, Pub. L. No. 99-514, 100 Stat. 2085, and dramatically changed the corporate tax rules. A number of years later, I cleverly changed the name of Advanced Corporate Tax to Corporate Tax II, astutely thinking that students might be less apprehensive about taking a course not called "Advanced Corporate Tax." Of course, the only students eligible to take Corporate Tax II are those who have taken Corporate Tax I.


6. Id. § 368.
anticipate new efforts to avoid its corrective legislation and simultaneously avoid penalizing taxpayers engaged in legitimate business or investment activities. These dual and often competing goals contribute to a web of special rules and exceptions. And so it is that the definition of personal holding company income in §543(a) is one of the Code's most diabolical provisions that may easily exceed your gloomiest expectations. 7

In this Article, I explain some of the causes for the bad rules in corporate tax. Then I provide an example of some ecstasy—logical and well-drafted rules. Next, I point out the sources of our agony—the diabolical and stupid rules that I have encountered in teaching this course. Finally, I recommend changes for improving corporate tax law.

II. SOME REASONS FOR THE SILLINESS OF RULES

A. Lack of Time

One of the reasons for some of the silliness and inconsistency in corporate tax law is the lack of time on the part Congress and its professional staff. Congress, of course, has many nontax matters to deal with. Moreover, political exigencies tend to eat up most of the legislature's allotted time for tax work. Who has time for looking seriously at the consideration requirements for tax free reorganizations when there is a “death tax” to repeal, a “marriage penalty,” and earned income tax credits for the working poor? Lowering or raising the rates is always popular. Capital gains and losses are always topical, though they sometimes degenerate into the arcane. Section 1257,8 for example, deals with the disposition of converted wetlands or highly erodible crop lands. There also is the need to deal with a gain from the disposition of §126 property,9 dealing with the excludable portion of payments received under, amongst other things, the rural clean water program,10 and the rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.11 How can Congress deal with minor rules like tax rules for mergers when the rural abandoned mine program is at stake?

Due to lack of time, Congress's formulation of corporate tax law has been mostly incremental and piecemeal.12 It just adds a little bit at a time, sometimes without even dovetailing the new rules with ex-

9. Id. § 1255.
10. Id. § 126(a)(1).
11. Id. § 126(a)(2).
isting statutory provisions. For example, the tax law has a substantial number of rules regarding the division of either a single corporation or a group of corporations, including a parent and at least one subsidiary, into two or more free-standing corporations. They go by the fun nicknames of a “spin-off” (parent making a dividend-style distribution of a subsidiary's stock); a “split-off” (a parent conveying a subsidiary's stock in redemption of the parent's own stock); and a “split-up” (a parent distributing subsidiaries' stock to the parent's shareholders in a liquidation of the parent). Such transactions are called “corporate divisions” and can be tax free, if various requirements are satisfied. Some of these requirements come from caselaw. Others are in the Treasury regulations. But most of them are contained in § 355.

The Code makes a minor and insignificant distinction between a “D” reorganization corporate division and a non“D” reorganization corporate division. If a parent needs to put some of its assets into a subsidiary before distributing the subsidiary's stock to the parent's shareholders, the transaction must satisfy the requirements of § 368(a)(1)(D) to be tax free. In other words, it has to be a “D” reorganization. The “D” reorganization status is needed only when the parent has to put assets in the subsidiary. For instance, suppose Arfie and Barfie, each fifty percent shareholders, want to divide their single corporation into two corporations. Each want to take half the business so they can go their separate ways. The corporation can “drop down” half of its assets into a newly created subsidiary and then proceed with the corporate division, i.e., a split-off. Arfie takes the whole subsidiary, while Barfie retains all of the parent's stock. To be tax free, the split-off must be a “D” reorganization as defined in § 368(a)(1)(D). Mainly, it must satisfy the rules in § 355. If it does so, it is a “D” reorganization corporate division.

Many times there is no need to do this “drop down,” such as when the subsidiary already exists and the parent and subsidiary are ripe for the corporate division. By meeting the requirements of § 355, the parties can proceed immediately to the division and have it be tax free. Without the “drop down,” this is not a “D” reorganization. But
we can say "so what?" The tax consequences are the same, because the important tax criteria are in § 355 and are the same for both transactions. Additionally, the economic effect of the transactions are virtually the same.

There is a silly, picayune difference, however. Section 361(c)\textsuperscript{16} allows a corporation that is a party to a reorganization to distribute its own "obligations" to its shareholders without recognizing a gain or loss.\textsuperscript{17} "Obligations" is a synonym for "debts" and includes short-term as well as long-term debts. The "obligation" is called "qualified property," which allows it to be passed tax free for the distributing corporation.\textsuperscript{18} This rule applies to "D" reorganizations. Section 355(c)\textsuperscript{19} provides a nearly identical rule for distributions in a tax free corporation division that is not a "D" reorganization. However, the subsidiary's debt must be a "security" for it to be distributed tax free.\textsuperscript{20} The term "securities" refers solely to "long-term" debt, whereas the term "obligations" covers any type of debt, short-term or long-term. Congress amended § 361(c) at the same time it added § 355(c) to the Code.\textsuperscript{21} It easily could have dovetailed the rules in §§ 355(c) and 361(c) regarding the distribution of debt. There is no important difference between the transactions described in the two sections. They cover basically identical transactions but contain this minute difference. With just a little more time and attention, these rules would be identical like they should be.

The history of forward and reverse triangular mergers, transactions described infra, further illustrates the incremental nature of corporate tax legislation. In the infamous Groman\textsuperscript{22} and Bashford\textsuperscript{23} cases, the Internal Revenue Service successfully argued that triangular acquisition techniques failed to qualify as tax free reorganizations. In Groman,\textsuperscript{24} the Supreme Court held that a forward triangular merger failed the continuity of interest requirement, because the shareholders of the target corporation received stock of the acquiring corporation's parent instead of the acquiring corporation itself. In

\begin{itemize}
\item \textsuperscript{16} Id. § 361(c).
\item \textsuperscript{17} Id. § 361(c)(1), (c)(2)(A), (c)(2)(B)(i); see 1 Boris I. Bittker & James C. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.11(1)(d) & ex.2 (7th ed. 2000).
\item \textsuperscript{18} I.R.C. § 361(c)(1), (c)(2)(A), (c)(2)(B)(i).
\item \textsuperscript{19} Id. § 355(c).
\item \textsuperscript{20} Id. § 355(c)(2)(B); 1 Bittker & Eustice, supra note 17, ¶ 11.11(1)(c) n.277.
\item \textsuperscript{22} Groman v. Comm'r, 302 U.S. 82 (1937).
\item \textsuperscript{23} Helvering v. Bashford, 302 U.S. 454 (1938).
\item \textsuperscript{24} 302 U.S. at 88-89; see David S. Miller, The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine, 3 Fla. Tax Rev. 187, 203-04 (1996).
\end{itemize}
Bashford, the Supreme Court again found a lack of continuity of interest, because the property acquired by the acquiring corporation was "dropped down" to its subsidiary as part of the reorganization plan. The reasoning of the Internal Revenue Service and Supreme Court in these two cases was spurious. They said that the shareholders did not continue their interest in the target corporation, a requirement for a tax free reorganization. However, the shareholders of the target corporation clearly continued their interest in the target by taking stock in a parent corporation that owned all the stock of a subsidiary that owned all of the target's assets.

 Eventually, the private sector convinced both the Internal Revenue Service and Congress that triangular techniques and "drop downs" were the economic equivalent of the tax free acquisition techniques authorized by § 368 and should also be tax free. In 1954, Congress authorized drop downs following an otherwise qualifying "A" and "C" reorganization, and eventually added a similar rule for "B" reorganizations. In 1967, the government held that a forward triangular merger did not qualify as a tax free reorganization, as the parent was not a party to the reorganization. However, it could qualify as a "C" reorganization if the conditions of that section were satisfied. Congress finally provided statutory approval of forward triangular mergers in 1968, adding § 368(a)(2)(D) to the Code. Though a forward triangular merger is basically a species of an "A" reorganization, § 368(a)(2)(D) creates a hybrid category of reorganization. It requires a mish-mash set of conditions taken from both the "A" and "C" reorganization rules.

The reverse triangular merger has a somewhat similar history. In Revenue Ruling 67-448, the Internal Revenue Service approved the structure as an authorized form of a tax free reorganization, but it had to meet the requirements of a stock-for-stock reorganization, known as a "B" reorganization. This creates a strict rule about the type of con-


consideration the acquiring corporation can use. Congress responded in 1971 by enacting current § 368(a)(2)(E), which approves reverse triangular mergers as tax free reorganizations. However, it requires still another mish-mash of requirements, some resembling “A” reorganizations and some resembling “B” reorganizations.

The end result: the Internal Revenue Code now has § 368(a)(2)(D) and § 368(a)(2)(E) approving forward triangular and reverse triangular mergers as tax free reorganizations respectively, each with its own set of requirements that are different from the requirements for all of the other of tax free acquisition techniques. Congress added the forward triangular merger rules to the Code in 1968. It added the reverse triangular merger rules in 1971. Ironically, the economic result of each of these two acquisition techniques is identical—the acquiring corporation has acquired the target and now holds it as a subsidiary. Why different Code requirements for basically identical transactions? Congress, it seems, did not take enough time to note that the substance of the transactions were identical. They should be covered by the same set of rules. As a distinguished writer recently said, “An otherwise rational proposal to reform the taxation of certain transactions . . . may be less sensible once consideration is given to broader patterns and inconsistencies in the tax law. Nowhere is this more true than in the corporate tax area and subchapter C of the Code.”

Reorganizations are always ripe for a profound review, but Congress has not made more than piecemeal changes in the last fifty years. Congress has had some excellent opportunities to evaluate fundamental reorganization issues. The organized tax bar, accounting groups, and the American Law Institute have provided Congress with ample studies of fundamental subchapter C issues in the early 1980s. The Senate Finance Committee took several years to write a

31. In a “B” reorganization, the acquiring corporation can use only its own voting stock to make the acquisition. I.R.C. § 368(a)(1)(B).
32. Id. § 368(a)(2)(E).
34. See I.R.C. § 368(a)(2)(E); 1 Bittker & Eustice, supra note 17, ¶ 12.22(3).
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did include several important recommendations in the new Internal
Revenue Code of 1986. However, for whatever reason, Congress did
not seriously evaluate the diamond in the crown of the American Law
Institute and Senate Finance Committee reports—a complete, new
system for tax free reorganizations.

B. Politics

Politics can make for untidy tax rules as recent events involving
the taxation of dividends vividly illustrate. The disparate treatment
of interest on corporate debt and dividends has never made much
sense. They are similar economically—routine periodic payments to
corporate investors. Moreover, the more favorable tax treatment for
interest often has been viewed as creating an improper incentive to
American corporations to over-leverage.

Still, changing the dividend rules has proven difficult, because
among other reasons, a decrease of the tax on dividends would result
in the loss of substantial tax revenue for the United States. In addi-
tion, many of the benefits would accrue to wealthy taxpayers. In early
2003, President Bush presented a relatively complicated proposal to
eliminate the tax on dividends paid to human shareholders. Its propo-
nents claimed to be motivated primarily by a desire to stimulate the
economy. They also claimed that the proposal constituted a salutary
reform of corporate tax law, removing the incentive for corporations to

N.Y. State Bar Ass'n, New York Bar Comments on Proposed Subchapter C
Changes, 20 TAX NOTES 679 (1983); Taxation Section Tax Force, Am. Bar Ass'n,
Income Taxation of Corporations Making Distributions with Respect to Their

39. STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., THE SUBCHAPTER C REVISION

40. For example, Congress continued the repeal of the General Utilities doctrine and
enacted the current § 382 pertaining to net operating loss carry forwards. See
(1986); Special Rules Relating to Dispositions and Deconsolidations of Subsidiary
1997, supra note 26, at 504.

41. See LIND 1997, supra note 26, at 504.

42. See, e.g., 2003 TAX LEGISLATION: JOBS AND KNOWN TAX RELIEF RECONCILIATION
ACT OF 2003: LAW, EXPLANATION, AND ANALYSIS ¶ 325, at 87 (CCH 2003) [herein-
after 2003 TAX LEGISLATION]; Peter C. Canellos, The Over-Leveraged Acquisition,
39 TAX LAW. 91 (1985); Kevin J. Liss, Note, Fraudulent Conveyance Law and

43. See generally Bob Davis & Peter McKay, Dividend Tax Cut Pleases Companies
More Than Investors, WALL ST. J., Aug. 5, 2003, at C1 (discussing the Bush Ad-
ministration's tax cut on dividends).
issue debt instead of stock. The proposal, though it had the good "pedigree, having evolved out of carefully crafted Treasury Department recommendations taking into account all possible ill effects of integration," had the two difficulties noted above. There was too much opposition in Congress to pass it as it was. Instead, a compromise ensued. The final result was a partial exclusion of dividends paid to humans. It is not a carefully constructed set of rules. Whether good or bad for the economy, the new rules are not good tax reform. Their creation was scarcely crisp and pristine tax law formulation.

C. Responding to Loopholes

One forever-recurring problem is the opening and closing of loopholes. The private sector constantly searches for weaknesses in the current tax system, looking for loopholes that save taxes. This constant probing often results in byzantine concoctions that are hard to understand even for the cognoscenti. Though the most important corporate tax law sections provide ordinary rules to govern common transactions, like § 301 on dividends, § 351 on incorporations, and § 331 and related sections on liquidations, loophole-closing sections abound. They often provide the most complex and, therefore, the silliest sets of rules.

Corporate tax law generally has "developed largely in a piecemeal fashion, as provisions have been added or modified to address specifically targeted problems or abuses[, ...] [producing] rules ... criticized as inconsistent and unnecessarily complex that produce uncertain and ... capricious results." Taxpayers resort to what is at the time a legal means to avoid taxation. The government responds with complex rules to limit avoidance. Taxpayers respond by inventing new complex transactions to circumvent the new rules. Both sides create a vicious cycle that leads to new, more complex rules and increasingly sophisticated and complex transactions.

The history of the collapsible corporation provides an illustration of this continuing process. The origins of the collapsible corporation were rather glamorous, involving Hollywood and famous movie

44. Heather Bennett & Patti Mohr, ABA Tax Section Midyear Meeting: Olson Dismisses 'Complexity' of Bush's Dividend Tax Cut, 98 TAX NOTES 662, 662-63 (2003); see 2003 TAX LEGISLATION, supra note 42, ¶ 325, at 88.
45. 2003 TAX LEGISLATION, supra note 42, ¶ 325, at 88.
47. Id. § 351.
48. Id. §§ 331-337.
49. McGowan, supra note 12, at 130.
One well-known case involved actor Pat O'Brien and the 1942 movie, *Secret Command*. The stars of the movie, the producer, and the director would form a corporation to produce a single movie. The incorporators would receive stock rather than salaries or royalties. Immediately after completion of the production of the movie, before it was shown in the theaters, the corporation would liquidate. The corporation would distribute the movie rights to the shareholders. Using the Code's liquidation sections, the shareholders would recognize a capital gain (or loss) and take a fair market value basis in the movie rights. At that time, liquidating distributions were tax free to the liquidating corporation. The tax consequences were absolutely beautiful for the taxpayers. There would be no double taxation and no ordinary income—just capital gain—for the shareholders, unless the revenues exceeded the fair market value of the movie rights. There would be no tax for the corporation because it never had any income. It never showed the movie, and thus had no revenue. If the net revenue from showing the movie in the movie theaters never exceeded the shareholders' basis in the movie rights, the shareholders would have no further income or gain, because the fair market value of the film rights was amortized against the proceeds.

The Internal Revenue Service unsuccessfully attacked collapsible corporations as tax-evasion devices under common law principles. After losing in the courts, the Treasury went to Congress for anti-collapsible corporation relief. Congress responded in 1950 with the catastrophe contained in § 341. All of § 341 was poorly drafted, and parts of it, notably the amnesty provision in § 341(e), epitomize the

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51. Much of this brief history is taken from 1 BITTKER & EUSTICE, supra note 17, ¶ 10.60.
52. O'Brien v. Comm'r, 25 T.C. 376 (1955). I would love to find a video or DVD of this title but have not found one so far.
53. Sometimes the shareholders would sell their shares to the studio, which would then liquidate the corporation. This would also produce a capital gain for the shareholders. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 17 (Comm. Print 1983).
54. The current § 336(a) taxes corporations on their liquidating distributions. I.R.C. § 336(a) (2000). This rule came into law in 1986. It replaced the General Utilities doctrine, which said that liquidating distributions to shareholders were nontaxable to the corporation. The doctrine is named after General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).
55. See 1 BITTKER & EUSTICE, supra note 17, ¶ 10.60. Receipts in excess of the film's basis were taxable as income. O'Brien, 25 T.C. at 385–86.
57. 1 BITTKER & EUSTICE, supra note 17, ¶ 10.60.
The prolix complexity of corporate tax at its highest pinnacle. The American Law Institute in 1982 described § 341 as "characterized by a pathological degree of complexity, vagueness and uncertainty."

The strategic desirability of using a collapsible corporation depended on both a preferential tax rate on capital gains and the corporation's ability to liquidate or sell property without recognizing a gain at the corporate level. When Congress repealed the General Utilities doctrine and made corporate distributions to shareholders of appreciated property taxable to the corporation, it made § 341 "almost a dead letter" and "little more than a bloated, but insignificant, relic from a bygone era." Nevertheless, it remained in the Code as a trap for the unwary until 2003, when Congress finally killed it.

D. Complex Transactions

Corporate tax is a complex subject matter. As one professor says:

Corporate taxation has a reputation, among law students at least, as one of the most difficult courses in the law school curriculum. This perception magnifies as Congress continues its seemingly endless amendment process, regularly revising . . . Subchapter C. . . . Some of these provisions appear eminently sensible and others do not. Few of them can be said to simplify . . .

59. Section 341(e) has been the subject of much gallows humor, including from the author of this article:

Section 341(e) epitomizes the incomprehensibility of Subchapter C of the Internal Revenue Code. Bittker & Eustice refer to § 341(e) as "labyrinthine." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.08 (4th ed. 1979). The first sentence of § 341(e)(1) has been nominated as the world's longest sentence. See J. SOBELLOFF, FEDERAL INCOME TAXATION OF CORPORATIONS & STOCKHOLDERS 189 (1981). This statement may be hyperbole, but the first sentence is 537 words long. Furthermore, subsection (e) has 12 sub-subsections, 19 sub-sub-subsections, and 18 sub-sub-sub-subsections. It has been amended 8 times since 1954 and refers to 9 other sections of the Code.

William J. Rands, Closely Held Corporations: Federal Tax Consequences of Stock Transfer Restrictions, 7 J. CORP. L. 448, 449 n.1 (1982). A leading casebook has noted that § 341 "is a statute of epic proportions, containing one infamous sentence [§ 341(e)] that is nearly twice as long as the Gettysburg Address." LIND 1997, supra note 26, at 700.

60. ALI, SUBCHAPTER C, supra note 38, at 111.

61. LIND 1997, supra note 26, at 701.

62. See supra note 54.

63. See supra note 54.

64. 1 BITTKER & EUSTICE, supra note 17, ¶ 10.60.

65. 1 Id.


67. BLOCK, supra note 3, at xxii.
Indeed, complexity has been identified as the tax system's biggest problem, especially for small businesses.68 A notion that taxes should be simpler evokes almost unanimous agreement. Paradoxically, the tax law becomes more complex almost every year.69 Much of the tax law's complexity is attributable to the complexity of corporate structures and transactions.70 Though simplification of the tax law is desirable, tax law cannot avoid a degree of complexity. After all, "American society and its economy are complex."71

One example of unavoidable complexity is the use of affiliated corporations. Though affiliated corporations provide some tax advantages,72 they provide multiple nontax benefits and are going to be

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70. One author suggests these four reasons for the complexity of our tax code:

   (1) Conflict among the consensus goals of tax policy: Competing policy objectives requires efforts to balance one or more goals against each other.

   (2) The political process: Politicians and interests groups want targeted subsidies that reduce taxes for particular groups or activities. Targeted subsidies inevitably make complexity by creating distinctions among taxpayers and sources and uses of income.

   (3) Deterring tax avoidance: The federal government often responds to tax avoidance efforts with complex rules designed to limit avoidance. Taxpayers respond by inventing complex transactions to circumvent the new rules. This creates a vicious cycle leading to more and more complex rules and increasingly complex avoidance techniques.

   (4) Increasing revenue: The government passed complicated provisions to raise revenue or limit revenue losses during times of rampant budget deficits.

   Id. at 1466.

71. Donaldson, supra note 50, at 660.

72. According to a leading casebook, these include: (1) Filing a consolidated return; (2) Using different accounting methods for taxable years; (3) Reallocation of income to avoid progressive tax rates; (4) Use of multiple tax benefits, e.g., the accumulated earnings tax credit; (5) Favorable disposition of unwanted assets, e.g., tax free spin-offs; and (6) Flexibility regarding earnings, profits, and shareholder distributions. RICHARD L. DOERNBERG & HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 525 (3d ed. 2000).
A system of affiliated corporations can become extremely complex. No law limits the number and tiers of subsidiaries that a corporation may have. A parent corporation may have ten tiers of subsidiaries and thousands of subsidiaries in those tiers. It seems impossible to avoid complex tax laws to deal with them.

Likewise, nontax reasons provide some of the motivation for using the complex transactions involved with forward triangular mergers and reverse triangular mergers. The reverse triangular merger is especially byzantine. In this transaction, an acquiring corporation either creates, or has in place, its own subsidiary to assist in the acquisi-

73. The Doernberg and Abrams business tax casebook lists them as follows:
   (1) Minimizing potential tort liability . . . ;
   (2) Regulatory restraints or benefits of combining businesses within a single corporation;
   (3) Avoiding state law complications;
   (4) Existence of favorable, nonavailable contractual arrangements;
   (5) Alleviation of labor problems; and
   (6) Existence of corporate good will.

74. The primary code sections on affiliated corporations are I.R.C. §§ 1501–1504, 1551–1552, 1561, 1563 (2000). These code sections are not necessarily easy to understand, but they pale in comparison to the regulations, which take up hundreds of pages. For example, the regulations for § 1502 start with Treasury Regulation section 1.1502-0 and reach section 1.1502-100. They take up 554 pages in Commerce Clearing House's looseleaf service. See 14 Stand. Fed. Tax Rep. (CCH) ¶¶ 33,141–33,206 (2003).

75. If a target merges into an acquiring corporation, the acquiring corporation inherits the liabilities of the target corporation by operation of state statute. This assumption of the liabilities is not particularly a problem for the liabilities on the target's books at the time of the merger. The acquiring corporation can factor those liabilities into the price paid. The real danger is inchoate liabilities, like future product liabilities claims. The acquiring corporation inherits these, too, even though they are not yet known. They cannot be factored into the purchase price.

In the forward triangular merger, the target merges into a subsidiary of the acquiring corporation. The subsidiary technically acquires the target, though the parent is the true party in interest. The parent's assets are protected from the target's inchoate liabilities, because those liabilities flow into the subsidiary, which probably was newly created and has no assets other than the target's assets acquired in the merger. Under the doctrine of limited liability, the subsidiary alone is responsible for the target's liability, except in the unusual circumstances that would permit a creditor to pierce the subsidiary's corporate veil.

76. Like the forward triangular merger, the reverse triangular merger prevents inchoate liabilities from flowing into an acquiring corporation. In the reverse triangular merger, the subsidiary of the true acquirer (the parent) merges into the target and the parent takes a controlling block of the target's stock. Thus, the target is kept alive. Therefore, it is responsible for its own liabilities.
tion of a target corporation. The subsidiary merges into the target and the target shareholders must receive at least some of the acquiring corporation's stock. The transaction is "triangular," because it involves three corporations: the subsidiary, the target, and the acquiring/parent corporation. Since this is an acquisition of the target, the target shareholders must surrender at least the majority of their shares to the acquiring corporation, even though the target corporation, not the subsidiary, survives the merger. Indeed, generally, the reason for using the reverse triangular merger usually is to keep the target corporation alive as a corporate entity. The target might own valuable but inalienable franchise or contract rights that would otherwise be lost.

There are several permutations for assuring that the right parties get the right shares of stock. The acquiring corporation can issue some of its own stock to the subsidiary and have the plan of merger require that the subsidiary distribute the stock to the target's shareholders upon the merger. Alternatively, the acquiring corporation can skip that rather ephemeral step of placing its stock in the subsidiary, and convey the stock itself, probably directly to the target's shareholders. The acquiring corporation could also perhaps convey the stock to the target, which then can distribute those shares to its own shareholders. The parties also need to craft a way to get target stock out of the hands of the target shareholders and to the acquiring/parent corporation. If the target is a closely-held corporation, this objective is easily accomplished. As all of the target shareholders likely are aware of the transaction and approve of it, they can convey their shares directly to the acquiring/parent corporation. The matter is more complicated when the target corporation is publicly held. Instead of expecting the target shareholders to transfer their stock to the acquiring/parent corporation, the target corporation might have the articles of merger amend the articles of incorporation to create a new class of stock with voting control of the target. The new stock is issued to the acquiring/parent corporation. The previously outstanding target stock might be reduced to a mere claim to be paid the target's consideration for the merger, such as the acquiring corporation's stock.

Triangular acquisitions raise technical problems regarding the application of the usual corporate tax rules. For example, § 1032(a)77 provides nonrecognition treatment when a corporation issues its own stock to acquire assets. Section 1032(a) makes good policy sense. In our capitalistic society, we want to enable our corporations to acquire capital by issuing stock without the impediment of tax. Moreover, the issuance of stock is not the same as operating a business. It does not produce business profits. This section applies with ease when the ac-

77. I.R.C. § 1032(a) (West 2002).
Corporation issues stock to a target or target shareholders in straightforward transactions, like a merger of a target into the acquiring corporation or a sale of target's assets directly to the acquiring corporation.

In the triangular acquisition techniques, however, § 1032(a) often does not literally apply. The parent is the true party in interest, but it is using a subsidiary to do the acquiring for it. Technically, a subsidiary is the acquiring corporation and the stock of the parent/acquiring corporation is the consideration paid to the target or the target's shareholder. The problem is that the "acquiring corporation," the subsidiary, does not issue its own stock. The Treasury Department issued regulations to take care of this technical glitch. The regulations make the transaction nontaxable to the parent and subsidiary under § 1032(a). This is the proper policy result. Everyone wants § 1032(a) to apply here. However, this certainly is not a perfect formulation of tax law—a regulation applying a rule from a code section to a transaction not covered by that code section. Section 1032(a) just has not caught up yet with the transaction's complexities.

III. CODE SECTIONS LIKE DIAMONDS

Though many corporate tax rules are byzantine, and maybe not even sensible, a few of them are gems—true diamonds. Section 351 and its related sections constitute one such gemstone.

In a nutshell, § 351 and related sections cover transfers of assets to a controlled corporation in exchange for the stock of that corporation. Neither the corporation nor the shareholder recognize a gain or a loss. Section 1032(a) provides nonrecognition for a corporation when it issues its own stock to acquire assets. Section 1032(a) applies whether or not the shareholder is entitled to nonrecognition under § 351. The corporation takes a carryover basis in its new assets (the same basis that the shareholder had in those transferred assets). Additionally, § 351(a) provides nonrecognition for the shareholders. It turns what otherwise would be an exchange of property creating a gain or loss for the shareholder into a nontaxable event. Generally, the exchange happens when the shareholder places assets in a corporation at the time of incorporation, but § 351(a) applies any time that its requirements are met. Section 358 provides what can be a relatively lengthy formula for determining a shareholder's basis in the new

79. Another technical problem addressed in the regulations is the parent corporation's basis in the subsidiary's stock after a triangular reorganization. For its resolution, see Treas. Reg. § 1.358-6 (1995).
81. Id. § 351(a).
82. Id. § 358.
stock received. Often, however, the shareholder merely takes the same basis that the shareholder had in the property transferred to the corporation.\textsuperscript{83} Section 357(a)\textsuperscript{84} assures that when the corporation takes property subject to liabilities or assumes liabilities, it does not destroy § 351 exchange status.

Since the shareholder usually takes the same basis in her new stock that she had in the property transferred, any potential gain or loss in the property stays with the shareholder through her basis in the stock. She will recognize it if she sells her stock, which, at least initially, probably is worth approximately the net value of the property transferred.

Section 351(a) contains three basic requirements: (1) A taxpayer transfers property to a corporation; (2) In exchange for this property, the transferor receives stock of the transferee corporation; and (3) Immediately after this exchange, the transferor controls the transferee corporation. The control required—80%—is defined in § 368(c).\textsuperscript{85}

The tax consequences can become more complicated if the corporation conveys something other than its stock to the transferors. This is known as “boot.” Also, liabilities can make things a little bit more complicated, although they usually do not. Even if boot is used or liabilities are present, the degree of complication is not overwhelming, and the rules make sense.

The nonrecognition and substituted/carryover basis rules are supported both by theory and policy. The theory is that a transfer of property to a controlled corporation in exchange for some of its stock is no more than a change in form.\textsuperscript{86} A much cited, older case states that the purpose of these rules is

to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in form of ownership and the taxpayer has not really “cashed in” on the theoretical gain, or closed out a losing venture.\textsuperscript{87}

The theory is easiest to comprehend in the case of a sole proprietor who incorporates her business. There is no substantive difference between an individual owning the property and that person's solely owned corporation owning the same property. It is like someone taking money out of her wallet and putting it into her bank account. The change from a proprietorship to a corporation is a mere difference in form, not a \textit{bona fide} disposition that should trigger a gain, a loss, or

\textsuperscript{83} Id. § 358(a). The vernacular for this kind of basis is “substituted basis.”
\textsuperscript{84} Id. § 357(a).
\textsuperscript{85} Id. § 368(c).
\textsuperscript{87} Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940).
even a change in basis. When she owns 100% of the corporation, the individual has not cashed in on a gain or closed out on a loss.

The theory behind § 351 sometimes falls down when a group of transferors, who heretofore have not been operating these assets, transfer them into a single business. For example, suppose four unrelated persons who have not been in business together decide that each will provide a newly formed corporation with an asset in exchange for 25% of its stock. The law is well settled that § 351 and its related sections will provide full nonrecognition for all taxpayers. Before the § 351 exchange, each person had complete dominion and a 100% economic interest in her asset. After the exchanges, each has a 25% interest in an entity that owns other property. That amounts to more than a change in form. It seems the transferor has cashed in on her piece of property, and perhaps, should be taxed on the transaction.

Thus, as the theory of a mere change does not fit, it is perhaps necessary to offer a policy reason for nonrecognition. Though not often articulated, an underpinning policy justifies § 351. In a capitalistic system, as exists in the United States, capital formation is an absolute necessity. Congress, at the very least, should avoid tax laws that would impede capital formation through incorporation. Certainly, the United States does not want its tax laws to interfere with the crucial transactions that fund its business enterprises.

Like virtually any corporate tax system, § 351 has its nooks and crannies that can complicate matters. Here, I have no intention of spelunking in every cave formed by § 351. However, for an example, some preferred stock, such as "nonqualified preferred stock," cannot be treated as stock for purposes of § 351(a).

Section 357(c)(1) and its directly related co-sections, § 358(a)(1)(A)(ii) and § 358(d)(1) illustrate how sensible section 351's rules usually are. Generally, in any exchange, a taxpayer transferring an asset encumbered by a liability must include the liability in her amount realized, because unloading of that liability is a tangible economic benefit. Most likely the transferee will pay off that liability to prevent losing the property. Section 357(a) provides an exception to this general rule when dealing with § 351 exchanges. Section 357(a) provides that the transfer of liabilities by the party receiving the shares in a § 351 exchange does not count as boot, which

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88. See Am. Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir. 1934); 1 BITTKER & EUSTICE, supra note 17, § 3.01.
89. S. REP. No. 67-275 (1921), reprinted in 1939-1 (pt. 2) C.B. 181, 188–89 (stating that nonrecognition provisions allow businesses to go forward with salutary readjustments).
91. Id. § 358(a)(1)(A)(ii).
92. Id. § 358(d)(1).
would create recognition of gain for the transferor under § 351(b).\textsuperscript{93} Moreover, the transfer of the liabilities does not prevent the exchange from coverage under § 351. When the aggregate basis of the assets conveyed to the corporation is less than the sum of liabilities transferred, however, § 357(c)(1) applies, and the transferor must recognize a gain equal to the sum of the liabilities transferred minus the sum of the basis of the assets transferred.\textsuperscript{94}

Section 357(a) is an exception to the general rule that the transfer of liabilities to another party is taxable income or gain to the transferor. Section 357(c)(1) is an exception to that exception. An exception to an exception is not unusual. Actually in this case, there is an exception to an exception to an exception (§ 357(c)(3)(A)), and an exception to an exception to an exception to an exception (§ 357(c)(3)(B)).

Section 358(d)(1) says the transferor must treat transferred liabilities as cash paid to him by the corporation when calculating his basis in his new stock. The stock's basis decreases by the amount of the liabilities under § 358(a)(1)(A)(ii), which requires a basis decrease equal to the amount of any money received by the transferor. The basis adjustment preserves any gain avoided by unloading the liability tax free based on § 357(a). The basis reduction accounts for the fact that any person buying the stock from the transferor will only pay a price equaling the corporation's equity in its assets. Combining the nonrecognition rule of § 351(c)(1) and the basis reduction rules for liabilities under § 358, the shareholder ultimately will recognize the same amount of gain or loss when later selling the stock. Once students see how this works, they are pleased with the neatness of this result.

Here is an example: Arfie, a human, owns this asset:

\[
\begin{array}{ll}
\text{fair market value} & \$100 \\
\text{basis} & \$20 \\
\text{liability encumbering asset} & \$30
\end{array}
\]

How much in cash would someone pay for this asset, if the asset remains encumbered by the liability? The answer is $70 cash: the fair market value of the asset, $100, minus the liability, $30, which is the owner's equity in this asset. Arfie's amount realized equals $70 cash plus $30 liability transferred, which equals $100. Arfie's gain is the amount realized, $100, minus his basis, $20, which ends up at $80.

If Arfie transfers this encumbered asset to a corporation for 100% of the stock, Arfie will not be entitled to complete nonrecognition under § 351(a) and § 357(a). Instead, he must immediately recognize

\textsuperscript{93} Id. § 351(c).
\textsuperscript{94} Id. § 357(c)(1).
a $10 gain under § 357(c)(1),\textsuperscript{95} because the $30 liability exceeds Arfie's $20 basis by $10. Arfie's basis in his stock? It is covered by the formula contained in § 358. His new basis equals his $20 basis in the asset transferred ("substituted basis") minus the $30 liability (treated as cash boot paid to him on account of § 358(d)(1)) plus his $10 gain recognized,\textsuperscript{96} which equals $0. How much would an outsider pay for Arfie's stock? Probably $70 in cash—because that is the corporation's net worth, as measured by the fair market of its assets minus its liabilities. The gain on the sale of the stock would be $70. Putting together the § 357(c)(1) gain on the § 351 exchange and on the sale of the stock, the total gain is:

\[
\begin{align*}
&\$10 \text{ gain on the } \S 351 \text{ exchange} \\
+&\$70 \text{ gain on the sale of the stock} \\
= &$80 \text{ total gain}
\end{align*}
\]

This $80 gain is the same as if Arfie had sold the property without incorporating. Neat! Of course, the bifurcation of the gain may result in splitting the tax in different years. Also, if Arfie had transferred an ordinary income piece of property to the corporation in the § 351 exchange, he likely transposed the $70 of gain from ordinary income into capital gain. Still, this is a likeable result. Theory says that § 351 exchanges are mere changes in form. Here, Arfie gets the same end result, whether he incorporates or not. How appealing?\textsuperscript{97}

IV. THE ABYSS OF THE CONTROL TEST

Often, people use the word "plethora" without knowing that it has a negative connotation. The speaker may use the word to refer to the existence or presence of much or many of something, maybe even a lot of good things. However, "plethora" actually means an excess of something and, sometimes, even an abundance of bad things. Used properly, with its negative connotation, "plethora" accurately describes the

\textsuperscript{95} Id. § 351(c)(1).

\textsuperscript{96} Section 358(a)(1) requires the transferor to increase his basis in the stock by the amount of gain recognized on the exchange. Id. § 358(a)(1)(B)(ii). In addition to recognizing gain in § 357(c)(1), a transferor can recognize a gain by receiving more routine kinds of boot and by transferring liabilities to the corporation without a business purpose for the transfer. See id. §§ 351(b), 357(b).

\textsuperscript{97} Not everyone finds the results from § 351 exchanges appealing. The Bittker & Eustice text notes that if the shareholder sells the stock and the corporation sells the property, each recognizes a gain or a loss because of the transferor's substituted basis and the corporation's carryover basis. Without these basis rules, there would be only a single gain or loss, recognized by the individual on the time of the § 351 exchange. This result, of course, is part of the basic system of double taxation for C corporations under the Internal Revenue Code. Nevertheless, this fine and wonderful treatise, which is really criticizing the two-tier taxation regime, calls this set of rules "confining, complicated, and costly." 1 BITTKER & EUSTICE, supra note 17, § 3.02[1].
“control” tests and rules contained in the corporate tax portions of the Internal Revenue Code. Multitudinous operative tax rules depend on whether a particular taxpayer owns a required percentage of the stock of a corporation. References to many of the control tests are set out in the margin. Some of the control tests require a taxpayer to own more than 50% of the stock of a corporation. For example, § 267 disal-

98. Stuart Lazar, The Definition of Voting Stock and the Computation of Voting Under Sections 368(c) and 1504(a): Recent Developments and Tax Lore, 17 VA. TAX REV. 103, 105 (1997).

99. The following list paraphrases some of the control tests.

I.R.C. § 52 (2000):
Special Rules.
(a)—"Controlled group" corporations for the purpose of computing work opportunity credit defined according to § 1563(a), except that "more than 50 percent" is substituted with "at least 80 percent" where it appears in § 1563(a)(1), and the determination shall be made without regard to the requirements § 1563(a)(4) and (e)(3)(C).

Losses, Expenses and Interest with Respect to Transactions Between Related Taxpayers.
(f)(1)—"Controlled group" for purpose of limiting deduction for losses uses the definition for controlled group from § 1563(a), but uses "more than 50 percent" rather than "at least 80 percent," and the determination shall be made without regard to the requirements in § 1563(a)(4) and (e)(3)(C).

Acquisitions Made to Evade or Avoid Income Taxes.
(a)—Control for the purpose of limiting deductions associated with acquiring losses is defined as ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of classes of stock of the corporation.

Redemption Through Use of Related Corporations.
(c)—Control for purposes of treating a stock redemption as a distribution is defined as 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock.

Transfer to Corporation Controlled by Transferor.
(a)—Control for controlled corporation as defined in § 368(c).
(c)(2)—Provides special control rule for distribution to shareholders when the requirements of § 355 or § 356 are satisfied.

Distribution of Stock and Securities of a Controlled Corporation.
(a)(1)(D)(ii)—Applies the "control" definition in § 368(c) as part of test for the purpose of determining when a corporation can distribute stock to a shareholder or security to a security holder without creating taxable income for the shareholder or security holder.
(d)(7)(A)—Applies related party rules § 267(b) and § 707(b)(1) to define a person.

I.R.C. § 368 (2000):
Definitions Relating to Corporate Reorganizations.
allows a deduction for a loss on a sale of property between a shareholder and that shareholder’s more than 50%-owned corporation. Other control tests require a taxpayer to own 80% or more of the stock of a corporation. Most important of these are § 368(c) and § 1504(a). Unfortunately, the various control tests tend to have trivial idiosyncracies that make them different. Unless a policy reason supports a particular set of idiosyncracies, this just makes no sense. How many distinctive sets of 50% or 80% control tests are needed? The answer would seem to be one each.

A. Different 80% Control Tests

Section 368(c) has an 80% control test control for, among other things, two of the most important corporate tax sections—§ 351, 101

(a)(2)(H)—Sets out whether a transaction qualifies under § 368(1)(D). When § 354(b)(1)(A) and (B) are met, “control” has the meaning given under §304(c).

(c)—Sets out the meaning of control for part I (except for § 304), part II, part III, and part V as “the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.”

Unrelated Business Taxable Income.

(b)(13)(D)(I)—Provides a definition of control for a corporation and a partnership.

Disallowance of the Benefits of the Graduated Corporate Rates and Accumulated Earnings Credit.

(b)—Defines control for purposes of §1551(a) as follows: Control under (a)(1) and (2), ownership by the transferor corporation or its shareholders or both with at least 80% of the total combined voting power of all classes of voting stock or at least 80% of the total value of share of all classes of the stock. Control under (a)(3), ownership by the five or fewer individuals in (a)(3) possessing at least 80% of the total combined voting power of all classes of voting stock or at least 80% of the total value of share of all classes of the stock of each corporation AND more than 50% of the total combined voting power of all classes of stock of each corporation, only to the extent such stock ownership is identical with respect to each ownership of stock. Section 1563(e) “constructive ownership” applies to this subsection in determining the ownership of stock.

Definitions and Special Rules.

(a)—“Controlled group” of corporations for the purpose of filing consolidated returns means any group of a parent–sub controlled group, brother–sister controlled group, and combined group. Each of these has a different control test.

(c)—Excludes certain stock from the parent–sub controlled group and the brother–sister group.

100. I.R.C. § 267(a)(1), (b)(2) (2000). For other sections using a 50% stock ownership control test, see id. §§ 269(a), 304(c), 318(a)(2)(C), 318(a)(3)(C).

the centerpiece of corporate organization, and § 368, defining reorganization.\textsuperscript{102} Section 368(c) defines "control" as "the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation."\textsuperscript{103} For the purpose of testing voting control, voting stock is aggregated and treated as a single class of stock.\textsuperscript{104} If the corporation issues nonvoting stock, § 368(c) requires ownership of at least 80% of each class of nonvoting stock.\textsuperscript{105}

Section 1504(a)(2) likewise has an 80% control for key corporate tax sections. For example, it provides part of the definition for an affiliated group of corporations,\textsuperscript{106} which in turn defines the requirements for when a group of related corporations can file a consolidated return.\textsuperscript{107} Section 1504(a)(2) also provides a rule for determining when subsidiary corporations can liquidate into a parent corporation tax free.\textsuperscript{108} Section 1504(a)(2) defines "control" as ownership of stock "possess[ing] at least 80 percent of the total voting power of the stock" and having "a value equal to at least 80 percent of the total value of the stock of such corporation."\textsuperscript{109}

Both § 368(c) and § 1504(a)(2) require ownership of at least 80% of the corporation's voting power. Although, the two sections use slightly different language, which is bad drafting. There is no substantial difference between the two tests in their voting stock requirements. They do differ, however, on their second requirements. Section 368(c) requires ownership of at least 80% of each class of nonvoting stock, while § 1504(a)(2) requires ownership of at least 80% in value of all stock. It really makes little sense to have two slightly different 80% control tests that are applied willy-nilly throughout the tax code.

Another mini-system, contained in § 1561 and § 1563, eliminates some of the benefits that otherwise would accrue through the use of multiple corporations.\textsuperscript{110} The limitation applies to the flummoxingly-

\textsuperscript{102} I.R.C. § 361(a) (2000).
\textsuperscript{103} Id. § 369(c); see Rev. Rul. 59-259, 1959-2 C.B. 115.
\textsuperscript{104} 1 BITTER & EUSTICE, supra note 17, ¶ 3.08[1].
\textsuperscript{106} I.R.C. § 1504(a) (2000).
\textsuperscript{107} Id. § 1501.
\textsuperscript{108} Id. § 332(b)(1).
\textsuperscript{109} Id. § 1504(a)(2).
\textsuperscript{110} These sections combat the following tax evasion technique: a business with a million dollars taxable income could divide itself into twenty corporations with $50,000 taxable income each, so that the entire one million dollars taxable income would be taxed at the lowest § 11 tax rate of 15%. Section 1561(a)(1) thwarts this scam by treating members of a "controlled group" as a single taxpayer for purposes of the § 11 tax rates. In this example, the one million dollars of taxable income would be treated as if it was earned by a single corporate taxpayer. Not even a legitimate business reason for operating through multiple cor-
defined "controlled group of corporations." As a leading casebook says: "The terms 'component members' and 'controlled group of corporations' are defined in Section 1563. Although simple in concept, these terms are defined in the Code and regulations with an extraordinary degree of complexity and specificity." Moreover, to those not versed in the intricacies of corporate tax law, this phrase, "controlled group of corporation," sounds confusingly similar to "an affiliated group of corporations," the term used in sections 1501 through 1504 and relevant to numerous tax rules, especially the ability to file a consolidated return. And, please, do not confuse either of these with a "qualified group" of corporations, a term used for attributing indirect foreign tax credits from lower tier foreign subsidiaries to a United States parent corporation. Despite the similarity in names, all these groups are independent of one another. They trigger different operative tax rules and have their own distinctive requirements.

Section 1563(a) defines two types of "controlled group of corporations"—parent–subsidiary controlled groups and "brother–sister controlled groups." Both types of "controlled groups" have as part of their control test the ownership of stock possessing at least 80% of the voting power OR stock possessing at least 80% of value of all stock. The affiliated group definition has an 80% voting AND 80% value test. What nitpicking differences! OR for one test. AND for the other. That is stupid.

B. The Value Tests

Sections 951 through 964 contain monumental United States international tax rules. When applicable, these rules can impose immediate United States taxation to some United States shareholders on certain types of income of "controlled foreign corporations," known vernacularly as "CFCs." A foreign corporation is a CFC when "United States shareholders" own stock, possessing more than 50% of the

111. LIND 1997, supra note 26, at 644.
113. Id. § 1563(a)(2).
114. See id. § 1563(a)(1)(A)–(B) (parent–subsidiary controlled group); id. § 1563(a)(2)(A) (brother–sister controlled group). The brother–sister controlled group definition in § 1563(a) contains an ownership requirement of more than 50% of the voting power or more than 50% of the total value of the all stock. Id. § 1563(a)(2)(B).
115. Id. § 1504(a)(2).
116. Id. § 964.
117. "United States shareholder" is not as broad as it sounds. It is a defined term. Mostly, it includes United States taxpayers owning 10% or more of the total combined voting power of the foreign corporation. Id. § 951(b).
value. As described above, the definitions of "affiliated groups" and "controlled groups" both also have value tests. In addition, other value tests are noted in the margin.

Congress added the value tests to prevent taxpayer manipulation. For example, prior to 1986, voting power alone determined “control” for CFC purposes. This led some United States parent corporations to “decontrol” their foreign subsidiaries by placing stock possessing at least 50% of the voting power in the hands of friendly foreign taxpayers, who the United States parent knew would not vote against it. The United States parent corporation would concoct a capital structure for the foreign subsidiary that reserved for itself far greater than a 50% economic interest in the foreign company. The Internal Reve-

118. Id. § 957(a).
119. See id. § 1504(a)(2)(A) (80% value test for affiliated corporation); id. § 1563(a)(1)(A), (a)(2)(A)-(B) (80% and 50% value tests for controlled groups of corporations). Other value tests are strewn throughout the code. See, e.g., id. § 267(b)(10) (value test for rule disallowing deduction on transactions between related parties); id. § 384(b)(2) (value test involved in rule regarding use of preacquisition losses to offset built-in gains). An affiliated group of corporations exists when the common parent owns at least 80% of the voting power and 80% of the total value of the subsidiary. Id. § 1504(a)(2)(A), (B). A parent company may elect to treat a foreign company as a domestic company if the parent company owns 100% of the capital stock. Id. § 1504(d). There are three types of controlled groups under § 1563:

(1) Controlled group if—

(a) stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and

(b) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations. Id. § 1563(a)(1).

(2) Brother-Sister group if—

(a) at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of the stock of each corporation; and

(b) more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Id. § 1563(a)(2).

(3) Combined group if—

(a) is a common parent corporation included in a group of corporations described in paragraph (1); and also

(b) is included in a group of corporations described in brother-sister group relationship. Id. § 1563(a)(3).
The Service complained in court—sometimes successfully, sometimes not—that the decontrolling arrangement was a ruse and that the United States parent still had more than 50% voting control. It argued the foreign corporation should be deemed a CFC. In 1986, Congress added the value test to § 957 to prevent this manipulative technique. The foreign corporation is a CFC if the United States parent has more than 50% in value or voting power of the foreign entity.

Similarly, in 1984, Congress added the value component to the § 1504(a) test to prevent this machination: a prosperous corporation acquires an insignificant economic stake in a corporation with net operating losses but also acquires more than 50% of the voting stock so it can file a consolidated return. It uses the losses as deductions against its own income. Congress added the value test to prevent the acquirer from just buying voting control to obtain the net operating loss deductions. The acquirer must buy stock constituting more than 50% of the loss corporation's value.

Whether justified or not, there is a disagreeable aspect to value tests. No matter what the exact percentage of stock ownership is, someone can argue that their ownership percentage does not correspond to the percentage of the corporation's overall value. Marketability discounts, control premiums, different classes of stock, stock transfer restrictions, liquidity problems for large blocks of stock—any of these features might make the value of the stock acquired different than the formal percentage of stock acquired. Valuation of equities is just plainly a difficult task, especially for shares not traded on an exchange. For example, it is easy to argue that 79% stock ownership has more than 80% of the value based on a control premium. But maybe that particular block of 79%-owned stock should be discounted, because, if put on sale all at once, it would flood the market and bloat the supply of shares available for purchase. Moreover, what if the articles of incorporation or a shareholder agreement give veto power to minority shareholders? In litigation, each side will proffer competing experts who will give grossly divergent valuations. Often the judge.

120. See, e.g., Koehring Co. v. United States, 583 F.2d 313 (7th Cir. 1978); CCA, Inc. v. Comm'r, 64 T.C. 137 (1975), acq., 1976-2 C.B. 1; Garlock, Inc. v. Comm'r, 58 T.C. 423 (1972), aff'd, 489 F.2d 197 (2d Cir. 1973).

121. I.R.C. § 957.


will disagree with both of them. Value tests are a morass. I hate them.

V. THE AUGEAN STABLES OF THE CONSTRUCTIVE OWNERSHIP TESTS

Part and parcel of the control requirements are the constructive ownership rules. They are numerous, and references to many of them are set out in the margin. Generally speaking, these various sets of


125. The following list paraphrases some of the references to constructive ownership in the Internal Revenue Code.

Losses, Expenses, and Interest with Respect to Transactions Between Related Taxpayers.
(c)—Defines constructive ownership for the purpose of when losses created by transactions between related taxpayers are deductible. The shareholder is considered to own stock owned directly or indirectly by:
(c)(1)—Corporations, partnerships, estates, or trusts where the taxpayer is a shareholder, partner, or beneficiary;
(c)(2)—Family;
(c)(3)—Partner;
(c)(4)—Defines family to include only brothers and sisters, spouse, ancestors, and lineal descendants.
(e)—Provides special rules for partnership regarding deductibility of losses.
(e)(3)(A)—Do not apply (c)(3) when dealing with partners.
(e)(3)(B)—Interests owned by or for a C corporation are considered as owned by or for any shareholder that owns 5% or more in value of the stock of the corporation.

Distributions in Redemption of Stock.
(c)—Constructive ownership as applied to § 302.
(c)(1)—In general, § 318(a) definition of constructive ownership applies with exceptions in (c)(2).
(c)(2)(A)—§ 318(a)(1) does not apply to § 302(b)(3), which provides for a stock redemption to be treated as a distribution in exchange for the stock, and not a dividend, if: the distributee does not have any interest in the corporation except as a creditor; the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of distribution; and the distributee meets the filing requirements with the Secretary.
(c)(2)(B)—Subsection (c)(2)(A) does not apply if any of the redeemed stock was acquired, within the ten years preceding the distribution date, from a person whose ownership would be attributable to the distributee under § 318(a).
(c)(2)(C)(ii)(II)—Defines related person for purpose of § 302(C) to mean “any person to whom ownership of stock in the corporation (at time of distribution) is attributable under [§] 318(a)(1) if the stock is further attributable to the entity under [§] 318(a)(3).”

Redemption Through Use of Related Corporations.

(c)(3)—Applies § 318's constructive ownership rules for determining by replacing the 50% limitation in § 318(a)(2)(C) and § 318(a)(3)(C) with 5%.

Constructive Ownership of Stock.
This section sets out attribution rules. The rules in subsection (a) apply to the following sections:

- § 302 (relating to redemption of stock);
- § 304 (relating to redemption by related corporations);
- § 306(b)(1)(A) (relating to disposition of § 306 stock);
- § 338(h)(3) (defining purchase);
- § 382(1)(3) (relating to special limitations on net operating loss carryovers);
- § 856(d) (relating to definition of rents from real property in the case of real estate investment trusts); and
- § 958(b) (relating to constructive ownership rules with respect to certain foreign corporations).

Gain or Loss Recognized on Property Distributed in Complete Liquidation.

(d)—Prohibits recognition of loss with certain distributions to related persons as defined by § 267.

Distribution of Stock and Securities of a Controlled Corporation.

(d)(8)—Applies § 318(a)(2) in determining whether an individual owns stock or securities in any corporation but substitutes 10% for 50%.

I.R.C. § 382 (2000):
Limitations on Net Operating Loss Carryforwards and Certain Build-Losses Following Ownership Change.

(i)(3)(A)—Applies § 318 construction ownership rules in determining ownership of stock with the following exceptions:

- (i)—The “members of family” provisions in § 318(a)(1) and (a)(5)(B) do not apply and an individual and all members of his family described § 318(a)(1) are treated as a single individual.
- (ii)—The 50% limitation “from operations” contained in § 318(a)(2)(C) does not apply and stock attributed under this section is treated as no longer being held by the entity from which it is attributed.
- (iii)—§ 318(a)(3) (attribution to partnerships, estates, trusts, and corporations) is applied only to the extent provided for in the regulations.
- (iv)—Deals with options.
- (v)—§ 318(a)(2) (attribution from partnerships, estates, trusts, and corporations) does not apply when: (I)—The attribution is from a corporation and the stock of which is not treated as stock under this section; or (II)—There is a similar attribution from another entity as described in subsection (I) above.

Definitions and Special Rule (Relating to Certain Stock Options).

(d)—For applying the percentages of ownership limits in § 423(b)(3), attributes to the individual any stock owned by “brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants.” It also attributes ownership for shareholders, partners, or beneficiaries any stock owned directly or indirectly by or for a corporation, partnership, estate, or trust.

rules treat taxpayers as owning shares of stock actually owned by designated related parties. The rules strive to prevent transactions between related parties from being treated the same as if between independent parties. They form part of the government's arsenal against tax evasion.

Bittker & Eustice, both referring to the important constructive ownership rules of § 318\textsuperscript{126} and commenting on constructive rules generally, said:

Deductions Limited to Amount at Risk.

(b)(3)(C)—Defines "related person" for the subsection as a person having a relationship specified in § 267(b) or § 707(b)(1) but substituting 10% for 50% in these sections. It also defines "related person" as any such person engaged in trades or businesses under common control as set out in § 52(a) and (b).

(b)(6)(D)—Defines "qualified person" as the same as "qualified person" in § 49(a)(1)(D)(iv), without the part dealing with financing from related persons if the financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons.

(c)(7)(D)(iii)—Looks to § 318(a)(1) to define members of an employee's family.

(c)(7)(E)(I)—Applies § 318(a) to the definition of "non-owner employee" with the substitution of 5% for 50% in § 318(a)(2)(c).

(c)(7)(G)—Applies § 269(A)(b)(2) and substitutes 5% for 10% in that section.

Unrelated Business Taxable Income.

(b)(13)(D)(ii)—Applies § 318 constructive ownership rules.

Definition of Personal Holding Company.

(d)(2)(A)—Disallows deductions in respect to compensation of personal services rendered by shareholders, which includes members of the shareholder's family as described in § 544(a)(2).

Rules for Determining Stock Ownership.

(a)(1)–(6)—Provides special attribution rules for personal holding company.

Transactions Between Partner and Partnership.

(b)(3)—Applies the constructive ownership rules in § 267(c), except for subsection (c)(3), which would attribute a partner's stock according to § 707(b)(1) and (2).

I.R.C. § 958 (2000):
Rules for Determining Stock Ownership.

(b)—Relating to constructive ownership rules with respect to certain foreign corporations.

Definitions and Special Rules.

(e)—Constructive ownership rules relating consolidated returns and resulting from options, attribution from partnerships, estate or trusts, corporations, spouses, children (minor, adult, and adopted), grandchildren, parents, and grandparents.

(f)(2)—Stock constructively owned through spouse, children, grandchildren, parents, and grandparents cannot be attributed twice.

\textsuperscript{126} I.R.C. § 318 (2000).
Intricately devised, § 318 is only one of several sets of constructive ownership rules prescribed by the Code, which rules differ among themselves in such details as the degree of family relationship warranting the attribution of stock from one person to another and in the way stock owned by a trust is allocated to its beneficiaries. Although in theory each set could be crafted to suit the transaction to which it applies, their divergencies are frequently trivial and almost always inexplicable.127

The application of constructive ownership rules usually is negative for the taxpayers. When applicable, the rules tend to take away favorable tax consequences.

The constructive ownership rules of § 318 and their application to the § 302(b)128 redemption rules illustrate. The § 302(b) redemption rules follow general themes of corporate tax law. If a stock redemption diminishes the shareholder’s proportionate interest in the corporation, the shareholder is cashing in, at least partly, on her investment and recognizes a capital gain or loss. If the redemption does not diminish her proportionate interest in the corporation, the shareholder is not cashing in. Instead, she is extracting cash from the corporation. This is a disguised § 301 distribution and is a dividend to the extent the corporation has earnings. For example, suppose that Barfie is a 100% shareholder of a corporation with $500 in earnings and profits. If the corporation redeems 25% of Barfie’s stock for $50, Barfie is still a 100% shareholder of that corporation. That $50 payment is identical to a dividend and will be treated that way.

Section 302 is the key section. Under § 302(a),129 if the redemption meets any of the tests in § 302(b), the redeemed shareholder is entitled to sale or exchange treatment. The shareholder recognizes a capital gain or loss as if she sold the stock. However, under § 302(d),130 if the redemption fails to meet any of § 302(b)’s tests, the redemption proceeds are treated as a § 301 distribution, meaning a dividend and ordinary income for the shareholder. Section 302(b) contains four tests: § 302(b)(1), § 302(b)(2), and § 302(b)(3) all require a reduction in the redeemed shareholder’s percentage of stock ownership.131 Section 302(b)(4)132 requires a partial liquidation of the corporation and is not relevant to this discussion.

Section 302(c)(1)133 requires the application of § 318’s constructive ownership rules in determining the percentage of stock ownership for the first three § 302(b) tests. In measuring a redeemed shareholder’s percentage of stock ownership, both before and after redemption, the

127. 1 Bittker & Eustice, supra note 17, ¶ 9.02[1] (citations omitted).
129. Id. § 302(a).
130. Id. § 302(d).
131. Id. § 302(b)(1)–(3).
132. Id. § 302(b)(4).
133. Id. § 302(c)(1). The rules are sometimes called “attribution” rules. For instance one rule attributes stock owned by a husband to a wife. Id. § 318(a)(1)(A)(i).
shareholder is deemed to constructively own the following: any stock actually owned by designated family members; any stock actually owned by entities in which the shareholder has an interest; and any stock on which the redeemed shareholder holds an option. If the redeeming shareholder is an entity, and not a human, it constructively owns shares actually owned by certain parties with interests in it. For instance, a trust constructively owns shares actually owned by its beneficiaries. Suppose the following:

- X Corp has 100 shares;
- Husband (H) owns 40 shares;
- Wife (W) owns 10 shares; and
- Wife, Inc. (owned solely by W) owns 50 shares.

X Corp redeems 25 of H's 40 shares. H's percentage of stock ownership diminished from 40% before the redemption (40 of 100 shares) to 25% after the redemption (15 of 60 shares). Without application of constructive ownership rules, H's diminution in percentage ownership will satisfy the disproportionate redemption test of § 302(b)(2). Since the redemption of H's shares would satisfy one of the § 302(b) tests, H would avoid ordinary income from a dividend and would be entitled to a capital gain (or loss). But the constructive ownership rules would have to be applied as follows:

1. By dint of the family attribution rule contained in § 318(a)(1)(A)(i), W's shares are attributed to H, her spouse, because a person constructively owns shares actually owned by the spouse.
2. By dint of entity-to-owner attribution rules contained in § 318(a)(2)(C), Wife Inc.'s shares are attributed to the sole shareholder W, because a shareholder constructively owns shares actually or constructively owned by her corporation.
3. By dint the family attribution rule contained in § 318(a)(1)(A)(i), the shares constructively owned by W are reattributed to her spouse H, because a person constructively owns stock actually or constructively owned by the spouse.

So what percentage of stock does H own before the redemption? The answer is 100%—his own 40 shares actually; and W's 10 shares and Wife Inc.'s 50 shares constructively. What percentage of stock does H own after the redemption? He still owns 100%, for the same

134. Id. § 318(a)(1).
135. Id. § 318(a)(3).
136. Id. § 302(b)(2).
137. Id. § 318(a)(2)(c).
138. Id. § 318(a)(1)(A)(i).
reasons. Thus, none of the § 302(b) tests requiring diminution in the shareholder’s percentage of stock ownership are met.\textsuperscript{139} He owned 100\% both before and after the redemption, due to application of the constructive ownership rules. Hence, payment of the redemption proceeds are treated as a § 301 distribution to him and ordinary income to the extent of the redeeming corporation’s earnings.

The previous discussion of the § 318 attribution rules, of course, is by no means complete. In Corporate Tax I, our class spends two full fifty-minute classes covering the key points. One issue—whether to waive family attribution rules in a redemption that completely terminates a shareholder’s interest—has so many points and counterpoints that Bittker & Eustice likens the rules to a “baroque fugue.”\textsuperscript{140} This provides some relief in class. We take a five minute break from our work to discuss whatever a “fugue” is. Usually, most of us do not know, but occasionally a classical music enthusiast tries to enlighten us.\textsuperscript{141}

Although, the § 318 rules may be more elaborate than is necessary, they generally make sense. For example, a person constructively owns stock actually owned by a spouse or parent; but, a cut-off rule prevents that shareholder from constructively owning stock really owned by a mother-in-law or father-in-law.\textsuperscript{142} One could object to the rule for giving adverse weight to certain transactions taking place as much as ten years before the redemption,\textsuperscript{143} but ten years is just a little overkill. Without the constructive ownership rules, shareholders could extract cash from the corporation and easily avoid unwanted dividend treatment through redemptions involving related parties.

\begin{itemize}
\item \textsuperscript{139} \textit{Id.} § 302(b)(1)-(3).
\item \textsuperscript{140} \textbf{1 BITTKER \& EUSTICE, supra} note 17, ¶ 9.04[3].
\item \textsuperscript{141} In music, “baroque” refers to “a style of composition that flourished in Europe from about 1600 to 1750, marked by expressive dissonance and elaborate ornamentation.” \textbf{THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 146} (4th ed. 2000). “Fugue” is “an imitative polyphonic composition in which a theme or themes are stated successively in all of the voices of the contrapuntal structure.” \textit{Id.} at 709. This definition was not much help to us in class, because most of us did not know the meaning of “polyphonic” and “contrapuntal.” “Polyphonic” is the adjective for “polyphony,” which means “music with two or more independent melodic parts sounded together.” \textit{Id.} at 1361. “Contrapuntal” refers to music that incorporates counterpoints. \textit{Id.} at 399. Is Handel’s Hallelujah Chorus a fugue? Bach is known for his fugues.
\item \textsuperscript{142} Section 318(a)(1)(A) applies the constructive ownership rules to spouses and parents but does not include in-laws. Section 318(a)(5) prevents application of the family attribution rules twice, which would be necessary to make a shareholder the constructive owner of stock owned by a mother-in-law. Without § 318(a)(5), stock owned by the mother-in-law would be attributed to her child under § 318(a)(1)(A)(ii) and thus to the child’s spouse under § 318(a)(1)(A)(i).
\item \textsuperscript{143} I.R.C. § 302(c)(2)(B)(i).
\end{itemize}
Yet the various sets of constructive ownership rules in the Code contain bizarre and ridiculous differences. For example, § 267(a)\(^{144}\) disallows losses on sales and exchanges between specified related parties. Section 267(c)(4)\(^{145}\) defines related parties, including certain family members. This time family includes "brothers and sisters, whether by the whole or half blood, spouse, ancestors, and lineal descendants."\(^{146}\) Section 544(a)(2),\(^{147}\) which provides constructive ownership rules for the diabolical definition of a personal holding company, likewise includes brothers and sisters. The § 318 rules do not include brothers or sisters and are otherwise different than these other sections.\(^{148}\)

Is there a legitimate, or even a plausible, reason for including siblings in one set of rules and not in another? Are siblings more likely to coordinate their tax avoidance efforts in personal holding companies than when having their stock redeemed in closely-held corporations? Maybe yes, maybe no, but the issue seems like asking, "how high is up?"

VI. PASSTHROUGH ENTITIES AND THEIR UNPRINCIPLED DIFFERENCES UNDER FEDERAL TAX LAW

In 1996, I published an article entitled *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*.\(^{149}\) In that article, I noted that choosing the best form of organization for a business is daunting, because it requires an analysis of the tax consequences of operating as a C corporation, an S corporation, a general partnership, a limited partnership, and a limited liability company. While writing that article, the Treasury Department proposed a new system in Notice 95-10, called "Check-the-Box."\(^{150}\) To a degree, the new system has cleaned up the problems relating to having so many systems for taxing the income of a business enterprise. By using a limited liability company, business enterprise owners can now attain limited liability and passthrough tax consequences without fulfilling the subchapter S corporation eligibility requirements. Moreover, the passthrough-type partnership tax consequences, offered by limited liability companies, are often more desirable than those accompanying subchapter S status. Nevertheless, the alternatives "facing the business lawyer [have]

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144. Id. § 267(a).
145. Id. § 267(c)(4).
146. Id. § 267(b)(1).
147. Id. § 544(a)(2).
148. Id. § 318(a)(1).
become varied, to the point of almost being bewildering. . . . Adding the federal income tax classification options yields twenty-three possibilities.”\(^\text{151}\)

Despite pundits' professed infatuation with limited liability companies and their attendant partnership taxation, new incorporations abound; and, contrary to the conventional wisdom, the S corporation is showing surprising vitality. In 1997, for the first time, a majority of corporate tax returns were filed by S corporations.\(^\text{152}\) It is estimated that S corporations will be the fastest growing type of business tax entity through 2005.\(^\text{153}\) Why not a mad rush to limited liability companies? Why the continuing popularity of the S corporation? Perhaps it is inertia. Supchapter S has been in place since 1958, and some practitioners may feel comfortable with it. It is easier to stick with the tried and true. Undoubtedly, some practitioners and several business owners may be ignorant of the advantages of passthrough/partnership taxation over subchapter S. Maybe it is that partnership taxation is far more complex than S corporation taxation. The added complexity may outweigh the benefit, especially for simple business structures that may have no need for the other benefits of partnership tax law. Not everyone needs to make the § 704\(^\text{154}\) special allocations. Furthermore, following what may be somewhat dubious advice, many business owners seem to be using the S form to avoid paying payroll taxes by denominating payments to themselves as dividends rather than compensation.\(^\text{155}\) Additionally, some S corporations already in existence probably want to preserve S status because there is a tax cost in transferring assets out of the corporation.\(^\text{156}\)

To be competent, a tax planner still must master the differences between partnerships covered by subchapter K and corporations covered by subchapter S. The planner also must know the intricacies of the ever-complex subchapter C. As an American Law Institute study recently stated:


\(^{153}\) Id.


\(^{156}\) Rands, *Passthrough Entities*, supra note 149, at 37.
If the three sets of rules produced more or less the same tax consequences in most situations, the choice among them might not be especially significant. But that is not the case. In any given situation, subchapter C, K, or S may provide an advantageous tax result for particular taxpayers.157

There is no pat answer as to which form is the best. And this does not even take into account specialized rules for conduits that some people need to know, like subchapter M for mutual funds and real estate investment trusts, subchapter L for insurance companies, subchapter H for banks and trusts companies, and subchapter F for tax exempt organizations and cooperatives.

As I argued in my earlier article, Congress should establish uniform rules for all conduits with respect to both tax consequences and eligibility requirements. Numerous proposals have been made to change this byzantine system,158 and Congress should carefully parse through them and adopt some changes. There are far too many abstruse differences between subchapter K and subchapter S, even though the basic system for each of them is so similar.

VII. "ONE FLEW OVER THE CUCKOO'S NEST"159: REORGANIZATIONS

Section 368(a)(1) contains a list of transactions known as reorganizations160 ("reorgs" for those of us in the know). Reorgs are transactions involving exchanges that, according to basic tax principles,


158. See H.R. 22, 108th Cong. (2003), which would establish a uniform passthrough entity regime. The proposed bill would combine the benefits of subchapter S and partnerships in a single system based on subchapter K. Closely held, domestic corporations could choose partnership status for federal tax. Subchapter S would be repealed. A 1999 American Law Institute report recommended that "all private business firms, no matter what their form of organization and organizational characteristics, [should be] taxed as conduits for income-tax purposes" with tax liability passing through to the individual owners. YIN & SHAKOW, REPORTERS' STUDY, supra note 157, at 1. It recommends retaining subchapter S and subchapter K (partnership rules) but with specific proposals for changes in both of them. See id.; see also George K. Yin, The Future Taxation of Private Business Firms, 4 FLA. TAX REV. 141 (1999).

159. KEN KESEY, ONE FLEW OVER THE CUCKOO'S NEST (1962). Kesey (1935-2001) was somewhat of a 1960s counterculture hero and guru. He was also a central figure in a nonfiction book about early hippies and LSD. TOM WOLFE, ELECTRIC KOOL-AID ACID TEST (1968). One Flew Over the Cuckoo's Nest became a play and a famous 1975 movie, starring Jack Nicholson. It won numerous Academy awards including best picture, director, actor, actress, and screen play. Academy of Motion Picture Arts and Sciences, THE OFFICIAL ACADEMY AWARDS DATABASE, at http://www.oscars.org/awardsdatabase/.

would be taxable events. However, for policy reasons Congress decided the exchange should not be taxable. Reorgs are made "tax free." The various parties are given "nonrecognition." Why? The theoretical underpinning is that the transactions are mere changes in form. Sometimes, but not always, this is accurate. In addition to theory, there is an underlying policy supporting tax free status. Congress has chosen not to impede the salutary readjustments of corporate structures necessary in a capitalistic society.

The Bittker & Eustice text politely calls the reorganization rules "extraordinarily complex, even for the Code." They are also crazy. The craziness is amply illustrated by the rules for acquisitive reorganizations, transactions whereby one corporation acquires the assets or the stock of another corporation. Section 368 lists five acquisition techniques. They are:

1. A merger of a target into an acquiring corporation (called an "A" reorganization because it is listed in § 368(a)(1)(A));
2. An acquiring corporation using its voting stock to acquire stock of the target corporation (called a "B" reorganization because it is listed in § 368(a)(1)(B));
3. An acquiring corporation using its voting stock to acquire substantially all of the assets of the target corporation (called a "C" reorganization because it is listed in § 368(a)(1)(C));
4. A forward triangular merger, which is a merger of a target corporation into a subsidiary of the acquiring corporation with the target shareholders taking some acquiring corporation stock (authorized by § 368(a)(2)(D)); and
5. A reverse triangular merger, which is a merger of a subsidiary of the acquiring corporation into the target corporation with the acquiring corporation obtaining a controlling block.

161. The regulations provide "except as otherwise provided . . . the gain or loss realized . . . from the exchange of property for other property . . . is treated as income or loss sustained." Treas. Reg. § 1.1001-1(a) (as amended in 1996).

162. See, e.g., Bazley v. Comm'r, 331 U.S. 737 (1947); 1 Bittker & Eustice, supra note 17, § 12.01[3].

163. For example, "F" reorganizations are mere changes in identity, form, or state of incorporation. I.R.C. § 368(a)(1)(F). Obviously, such transactions are not true realization events.

164. A merger of a small, closely held corporation into a large, publicly-traded corporation is an "A" reorganization, provided the shareholders in the closely held corporation receive some of the publicly held corporation's stock. The merger is scarcely a mere change in form for the shareholders of the closely held corporation. See 1 Bittker & Eustice, supra note 17, § 1201[2].

165. See, e.g., S. Rep. 67-275 (1921), reprinted in 1939-1 (pt. 2) C.B., 181, 188-89. This report is noted in Lind 2002, supra note 152, at 405, 405 n.3.

166. 1 Bittker & Eustice, supra note 17, § 12.01[4].

167. I.R.C. § 368(a)(1)-(2).
of the stock of the target corporation and the original shareholders of the target taking the acquiring corporation's voting stock (authorized by § 368(a)(2)(E)).

The end result in both the "A" and "C" reorg is the same: the target corporation no longer exists; the acquiring corporation owns some or all of the target's assets; and at least some of the target's shareholders own stock in the acquirer. In the "B" reorg and the reverse triangular merger reorg, the target stays in existence but becomes a subsidiary of the acquirer, and the target's shareholders own stock of the acquirer. "A" and "C" reorgs followed by a drop-down of the acquired assets to a subsidiary have exactly the same end result as the "B" and reverse triangular merger reorgs. The result of the forward triangular merger reorg is different from the "B" and the reverse triangle merger, but only in a formal way—the target no longer exists because it has merged into a subsidiary of the acquirer. However, this subsidiary is virtually identical to the target, as it must own substantially all of the target's assets. Triangular "C" reorgs have the same end result as the "A" and "C" reorgs with a drop-down, the "B" reorg, and the reverse triangular merger reorg.

Intrinsically, of course, the form of the acquisition technique makes no difference. The acquiring company can acquire the target by acquiring all of its assets or all of its stock. It does not matter whether it acquires its assets through a merger or by a direct purchase. It does not matter whether it holds the assets directly or drops them down to a subsidiary. If the acquiring corporation acquires a target's stock, it does not matter whether it acquires it in a direct purchase, a forward triangular merger, or a reverse triangular merger. No matter which acquisition technique is used, the end result is economically the same. The acquirer has acquired the target and now owns it.

Despite the economic equivalence of these acquisition techniques, the tax law has distinctive, nitpicking rules for each kind of acquisition technique. Though this is very good for providing employment for tax professionals, most importantly law professors, it makes no sense.

168. The listing in the text does not include triangular "B" and "C" reorganizations, where the subsidiary of the acquiring corporation acquires the stock or substantially all of the assets of the target corporation respectively. See id. § 368(a)(1)(B)-(C). These techniques are not substantially different from the regular "B" and "C" reorganizations. The Code also allows the acquiring corporation to drop down whatever it receives to its own subsidiary without disqualifying the transaction as a reorganization. Id. § 368(a)(2)(C).

169. The Code requires the target corporation selling its assets in a "C" reorganization to liquidate after the sale. Id. § 368(a)(2)(F)(i). The liquidation puts the target out of existence. The Internal Revenue Service can waive the liquidation requirement. Id. § 368(a)(2)(F)(ii).
There is not enough room in this Article to describe all the different rules, but here is one for purposes of illustration.

Each of the five primary acquisition techniques has its own requirements for the type of consideration that the acquirer must use to pay for the acquisition. The "A" reorg has the most lenient rules. They are not in the Internal Revenue Code but instead come from the common law and the regulations. To qualify as an "A" reorg, target shareholders must be paid at least partly with acquiring corporation stock. It need not be common stock or voting stock. It can be nonvoting preferred stock. This requirement is called continuity of interest and, sometimes, continuity of proprietary interest. Though the Internal Revenue Service will rule privately that this requirement is met if at least 50% of the consideration paid to the target shareholders is the acquirer's stock, ancient cases provide the real benchmark. Twenty-five percent voting common stock is enough. Thirty-eight percent redeemable, nonvoting preferred is enough. Sixteen percent voting common stock is not. A more recent case inferred that 22% voting common stock is not enough. Acquirers should feel comfortable that the requirement is satisfied by using 25% common stock. Seventy-five percent of the consideration can come from other sources, such as cash, to pay the target shareholders in the merger.

The Internal Revenue Code prescribes the consideration requirements for "B" and "C" reorgs. The "B" reorg rule is simple. The acquirer can use only its own voting stock to pay for the acquisition. The "C" reorg rules are fairly complicated and there really is not enough room to discuss them in complete detail here. Section 368(a)(1)(C) states that acquirer can use solely its own voting stock (in language identical to the rule for "B" reorgs in § 368(a)(1)(B)), but in actuality, this is inaccurate. Section 368(a)(2)(D)(i) allows the acquirer to use other forms of consideration and still have a "C" reorg, provided that acquirer uses enough of its own voting stock to pay for 80% of the fair market value of the target's assets. This rule allows


173. See, e.g., Miller v. Comm'r, 84 F.2d 415 (6th Cir. 1936).


178. Id. § 368(a)(1)(C).

179. Id. § 368(a)(2)(D)(i).

180. Id. § 368(a)(2)(B).
the acquirer to use consideration other than its own voting stock in an amount up to 20% of the fair market value of all the target’s assets, if the acquirer buys 100% of the target’s assets and it takes on no target liabilities.

In a much-watched case, a taxpayer argued that the acquirer ought to be able to use consideration other than its own voting stock in a “B” reorg if it uses its own voting stock to acquire 80% or more of the target’s stock. This argument did win in several lower courts. However, unlike for “C” reorgs, the Internal Revenue Code does not have a section allowing for this leniency in “B” reorgs. At the circuit court level the argument was rejected, and the law now seems settled. Thus, “B” reorgs require using acquirer voting stock exclusively as the consideration. Conversely, “C” reorgs require using acquirer voting stock primarily, but sometimes allow for a little boot.

For the most part, forward triangular merger reorgs follow the lenient consideration rules for “A” reorgs. The subsidiary, which technically is the acquiring corporation, must use enough of the parent's stock to satisfy the continuity of proprietary interest requirement. Just as if the transaction was an “A” reorg between the parent and the target, the consideration needs to consist of merely 25% parent stock. Seventy-five percent boot or cash is allowed. The 25% stock component must be the stock of the subsidiary’s parent. According to a very odd rule in the Code, the subsidiary cannot use any of its own stock and still satisfy the forward triangular merger reorg section.

Section 368(a)(2)(E)(ii) provides the consideration requirements for a reverse triangular reorg. They are different than all of the other consideration rules. The acquirer must obtain at least 80% of the target’s stock in one transaction and pay with enough of its own voting stock to equal at least 80% of the value of the target’s stock. For example, if the acquirer obtains 90% of the target’s stock in a merger of the acquirer’s subsidiary into the target, eight-ninths of the consideration paid by the acquirer must consist of its voting stock. One-ninth of the consideration can be anything else, such as cash. This somewhat resembles the consideration rule in the Code for “C” reorgs.

All in all, there are five consideration rules for the five basic types of acquisition reorgs, even though all five types of reorgs have the

182. Chapman v. Comm’r, 618 F.2d 856 (1st Cir. 1980).
183. Section 368(a)(2)(D)(ii) says that the transaction must qualify under the “A” reorg rules. This means that the forward triangular must meet the continuity of proprietary interest rules for “A” reorgs. See Treas. Reg. § 1.368-2(b)(2) (as amended in 2003); 1 Bittker & Eustice, supra note 17, ¶ 12.25[4].
185. Id. § 368(a)(2)(E)(ii).
same basic economic result—one corporation acquiring another corporation. These variances are the result of the incremental and piece-meal nature of change in corporate tax. They are not supported by policy or theory.

VIII. CONCLUSION

I conclude with recommendations on how to eliminate some of this “agon" in corporate tax.

A. Dovetailing

Congress should dovetail new legislation with the current code. This is an obvious point, but Congress has not always done it. An example is noted earlier in this paper: § 361(c)(2)(B)(i) allows a corporation to distribute any debt of the corporation (called “obligations”) tax free in a “D” reorganization corporate division, while § 355(c)(2)(B) limits tax free treatment in a non “D” reorganization division to long-term debts (called “securities”). Both should use either the word “obligations” as does § 361(c)(2)(B)(i) or the word “securities” as does § 355(c)(2)(B)(i). It would be understandable if the dovetailing is done in a technical corrections act, but it is hard to see why it cannot be done.

B. Control Tests

There are far too many control tests. Congress should synthesize them into two basic tests: an 80% test and a 50% test. In some instances there may be solid policy reasons for retaining or adopting tests other than the two basic tests, but probably not very often. The new tests could be placed in § 7701, which contains numerous definitions. Though I personally dislike value tests for their inexactitude, there often are good reasons for them. Why not have all the value tests require the appropriate percentage of both the voting power of the corporation and the value of all of the stock of the corporation?

C. Constructive Ownership Rules

Congress should synthesize all of the constructive ownership rules into one rule, which could be placed into § 7701. Again, if there are solid policy reasons for a rule different than the new basic rule in § 7701, then by all means, Congress should formulate a different rule. However, corporate tax law can be much simplified by switching to one basic rule to be applied most, if not all, of the time. After all, why include siblings for some rules but not for others?

186. I.R.C. § 7701 (West 2002).
D. Passthrough Entities

Congress should settle on one set of eligibility requirements and one set of tax consequences for passthrough entities. Currently, a limited liability company can have a nonresident alien as an owner, but an S corporation cannot. A partner can add entity-level debt to his basis, but an S shareholder cannot. These distinctions do not make sense. More importantly, the law of federal taxation of business organizations can be greatly simplified by settling on a single set of standard rules. Simplicity is especially desirable in this context, because choice of business form is such a common issue—and one that is often confronted by people who lack expertise in tax law.

E. Reorganizations

This is an area that was ripe for reform even upon adoption of the Internal Revenue Code of 1954, which contains a majority of the rules still in the Code. Short of fundamental reform, there is at least one change that would greatly reduce the complexity of our current byzantine system. That would be to decide on a uniform consideration requirement for every type of acquisitive reorganization. It makes no sense for each form of acquisition to have a distinctive rule for the type of consideration that the acquiring corporation must use to achieve a tax free transaction. In some instances, the requirements are wildly different: 25% common stock and 75% other consideration is acceptable in a merger ("A" reorganization rules); but 100% voting stock is required in stock acquisition ("B" reorganization rules). Settle on one rule!