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Continuity as the Key to Reform of Section 355

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RESPONSES

CONTINUITY AS THE KEY TO *REFORM OF SECTION 355*

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This piece is a Response to Brett Wells's article, Reform of Section 355*, which appears in Volume 68 of the* American University Law Review.

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INTRODUCTION

There can be little doubt that Internal Revenue Code (Code) section 355[1] is overly complex; the piecemeal adjustments spanning multiple decades could serve as exemplars of the potential pitfalls of incremental reform.[2] Revisions to section 355 have tended to be under- or over-inclusive because they are reactive to particular deals, yet they leave largely intact older structures that dealt with different deals. The result is a jumble of provisions that fail to implement a coherent, principled approach to the tax treatment of corporate divisions. In *Reform of Section 355*, Bret Wells urges changing Code section 355 to

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1. I.R.C. § 355 (2012) (codifying distribution of stock and securities of a controlled corporation).

2. *See* Bret Wells, *Reform of Section 355*, 68 AM. U. L. REV. 447, 455 (2018) (providing overview of section 355's complexity and history).

focus on the continuity of historic shareholders and historic assets. The proposals Wells suggests are grounded in congressional intent, specifically the rise and fall of the *General Utilities* doctrine and its role in the taxation of corporate divisions.[3] This Response to *Reform of Section 355* explores the continuity concept and considers the extent to which, if there were conflicting readings of congressional intent or changes to congressional intent, the use of the continuity concept to guide section 355 reform would remain a principled choice.

I. THE CONTINUITY CONCEPT

Under an ideal income tax, taxpayers would be required to account for increases in the value of all their assets and decreases in the value of their investment and business assets at least annually.[4] Instead, as implemented, the income tax system generally requires taxation of asset value increases and allows loss deduction for business or investment asset value decreases only if something occurs to cause a significant discontinuity with respect to an individual's relationship to the asset. This is generally referred to as the realization requirement,[5] but closer consideration of various Code provisions suggests that mere technical realization frequently does not trigger tax gains and losses. To take a basic example, if taxpayer *A* purchases land as an investment for $50,000 and nearby development causes the land to increase dramatically in value to $300,000, taxpayer *A* pays no federal income taxes on that increase unless something occurs to disrupt taxpayer *A*'s ownership interest in the land. If taxpayer *A* sells the land for cash, the $250,000 of gain will be both "realized" and "recognized," to use the tax terminology.[6] If instead taxpayer *A* exchanges the land for a different tract of investment land, the $250,000 of gain is realized, but

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3. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935) (permitting a corporation to liquidate its assets at a profit and pass on the profit to its shareholders without paying a corporate tax).

4. This is a restatement of the Haig-Simons definition of income—a definition that itself has been the subject of much discussion and debate—a more detailed consideration of which is beyond the scope of this brief Response. *See, e.g.*, Charlene Luke, *What Would Henry Simons Do?: Using an Ideal to Shape and Explain the Economic Substance Doctrine*, 11 HOUS. BUS. & TAX L.J. 108, 127 (2011).

5. *See* I.R.C. § 1001(a) (codifying the computation of gain or loss when determining amount of and recognition of gain or loss); *see also, e.g.*, Luke, *supra* note 4, at 141–43.

6. I.R.C. § 1001 (codifying the determination of amount of and recognition of gain or loss).

the tax system treats the disruption to *A*'s ownership as not sufficiently significant to require gain recognition (or allow a loss deduction).[7]

If, given the political and (possibly) actual impracticality of a mark-to-market system, one assumes the need for a second-best approach to determine the timing for the taxation of asset gains and losses, using lack of continuity may offer several advantages.[8] Taxpayers may be more likely to perceive the occurrence of a discontinuity in ownership as a fair time to be taxed.[9] Discontinuity events are also more likely to facilitate valuation and provide liquidity to pay the tax owed.[10] Further, such events may be the last opportunity to tax an increase (or allow a loss deduction) before the asset moves beyond the reach of the tax system with respect to a particular taxpayer.[11]

Because, however, tying tax consequences to continuity is a pragmatic concession to the difficulty of implementing mark-to-market taxation, there will not necessarily be consensus regarding the right place to draw the line between realization requiring recognition and a technical realization event that can continue to be ignored. Still, some patterns and factors emerge. Turning an asset into cash through a voluntary sale or exchange will be a change sufficient to require gain recognition,[12] but even a cash sale may be insufficient to allow a loss if the property is sold to a family member[13] or if the property is fungible and a new unit is

7. *Id.* § 1031 (codifying nonrecognition for like-kind exchanges of real property held for investment or business use). In 2017, for example, Congress significantly altered the like-kind exchange provision to remove the possibility of using the provision for property other than real property. Pub. L. No. 115-97, § 13303, 131 Stat. 2054, 2123 (2017).

8. *See generally* Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 78 (2011) (proposing a disposition standard of realization as a second-best alternative).

9. *See, e.g.*, Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75 (2003) (arguing that "requiring a realization event is generally the best way to measure taxable income because it is largely consistent with how individuals actually perceive income").

10. *See* Kwall, *supra* note 8, at 96–99.

11. *See id.* at 115 n.211.

12. For involuntary transformations of assets into cash (e.g., through condemnation awards or insurance proceeds for a casualty loss), I.R.C. section 1033(a)(1) provides taxpayers with a path to restore continuity and defer tax consequences by investing the involuntarily obtained cash proceeds "into property similar or related in service or use to the property so converted."

13. *Id.* § 267(a)(1), (d) (disallowing current loss deduction on sale of assets among certain related parties but allowing reduction to future gain by amount of disallowed loss).

purchased soon thereafter.[14] A list of factors relevant to analyzing continuity would include the presence of cash or cash substitutes, the relatedness of transferor(s) and transferee(s), continuing access to or control of the asset by the transferor after the change, the voluntariness of the change, and the similarity or fungibility of the asset(s) held before and after the change.

The corporate context further complicates the application of the continuity concept. The incidence of corporate taxation must, as an economic matter, ultimately fall on flesh-and-blood persons.[15] In an ideal income tax, arguably corporations would not be treated as taxpayers in their own right;[16] instead, increases and decreases would be marked-to-market and passed through to individual taxpayers.[17] Even assuming the (for now) permanence of a separate corporate tax and the lack of a mark-to-market system, the case for deferring tax on corporate gains is less strong. Corporations may have greater ability to address liquidity concerns through borrowing and to obtain valuation of assets, and corporations do not themselves perceive fairness (although of course their flesh-and-blood owners, managers, workers, and clients do). The barriers to creating a corporation that is respected as a separate taxpayer are very low, allowing relatively easy access to artificial arrangements and creation of endless "relatives."[18] Setting the line where there is sufficient continuity to delay tax consequences will be more difficult because of the greater ease with which corporate structures can be manipulated. And once the line is set, corporations likely have better access to the resources needed to avoid that line. Finally, Congress may be more easily swayed by competing considerations, such as tax rules perceived as pro-business.[19]

Consider, for example, an individual taxpayer who transfers a commercial building to a corporation in exchange for 100% of the

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14. *Id.* § 1091 (disallowing loss for wash sales of stock or securities).

15. *See* Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208, 342 (2017) (discussing the possible groups of individuals on which the corporate tax falls, including a summary of recent literature).

16. *See generally* Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 592 (2008) (arguing against the continuation of a corporate income tax).

17. *See* Kleinbard, *supra* note 15, at 349–50.

18. *See, e.g.*, Charlene D. Luke, *Captivating Deductions*, 46 HOFSTRA L. REV. 855, 858, 870 & n.77 (2018).

19. Arguably, virtually the entirety of the business entity provisions contained in 2017's Tax Cut and Jobs Act illustrate this possibility. Pub. L. No. 115-97, §§ 13001–1400Z-2, 131 Stat. 2054, 2096–2188 (2017).

corporation's stock; although there has formally been a change—because the taxpayer has exchanged a building for corporate stock—the taxpayer has experienced a fairly minimal disruption to the taxpayer's ownership of the building. In this situation, section 351 provides the rules to determine whether an exchange of assets for stock does or does not require recognition of any built-in gain or loss in the contributed assets to the contributors.[20] The continuity measurements incorporated into section 351 are fairly robust,[21] but certainly, it is easy to imagine more stringent requirements—for example, requiring the contributors to maintain corporate ownership for a minimum period of years, imposing a limit on the number of property transferors, and/or increasing the required level of control to higher than 80% of the vote and 80% of each nonvoting class. At the same time, it is also fairly unlikely that Congress will substantially change the continuity measures required by section 351 because policy goals beyond strict adherence to continuity affect congressional decision-making—for example, the facilitation of business growth.[22]

Allowing nonrecognition of gain to shareholders on the contribution of assets to a controlled corporation in exchange for corporate stock might seem to suggest a corollary: allowing nonrecognition of gain to the corporation on distributions of its assets, at least in some situations. As carefully and clearly elaborated in Professor Wells's article, at one time, corporations, under *General Utilities*, were able to distribute appreciated assets without recognizing gain, but over the course of multiple statutory amendments, and particularly the enactment of current Code section 311(b) in 1986, on the gain side, *General Utilities* has been nearly completely overturned.[23] There are now, essentially, only two situations when a corporation may distribute its own appreciated assets[24] to a shareholder without triggering gain recognition

20. I.R.C. § 351 (2012) (codifying the general rule for transfers to corporations controlled by the transferor).

21. For an overview of the requirements, see MARTIN J. MCMAHON, JR. ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS 55–59 (5th ed. 2019).

22. This is not to suggest Congress would never adjust. It has stepped in, for example, in the case of certain investment companies. *See* I.R.C. § 351(e) (codifying exceptions to transfers to corporations controlled by the transferor).

23. *See* Wells, *supra* note 2, at 460 n.45, 465 & n.58.

24. The use of the description "its own" is intended to differentiate the situation where an acquired target corporation receives stock or assets from an acquiring corporation that it distributes, acting as a conduit, to target shareholders. For a discussion of the Code sections providing the target with nonrecognition in the acquisitive reorganization setting, see David Hasen, *Asset Basis in Acquisitive*

for itself: (1) a liquidating distribution made to a corporation owning at least 80% of the liquidating corporation[25] and (2) a distribution of a controlled subsidiary to one or more of its shareholders as part of a Code section 355 division. Professor Wells focuses on section 355, but his (correct) assertion that access to corporate-level nonrecognition in the corporate division context is in need of further narrowing can be seen even more clearly if one considers the threshold for nonrecognition in the case of controlled subsidiary liquidations.

The reason generally given for why liquidation by a subsidiary does not trigger tax to the subsidiary is that this would generate at least three levels of tax—once at the subsidiary level, a second on receipt by the parent, and a third when the parent distributes to its shareholder—and the corporate tax is intended only to impose two layers of tax.[26] This reasoning relies on the tacit assumption that the two corporations are not separate taxpayers in the same way that two unrelated individuals or corporations are separate taxpayers. In terms of continuity, even though the subsidiary is ending its existence, because of the relationship between the distributee parent and the liquidated subsidiary, the discontinuity that occurs with respect to the distributed assets is relatively inconsequential. The parent corporation does not acquire any additional control over the subsidiary's assets through the liquidation; as the parent corporation owning 80% or more of the subsidiary, it could have caused the subsidiary to sell or distribute those assets at any time, and it would have controlled the subsidiary's initial acquisition and operation of its assets.[27] The parent inherits the subsidiary's basis in its assets as well as its tax attributes, so that if the parent sells or distributes the assets received in the liquidation, it will recognize gain, and the amount is measured with reference to the subsidiary's basis.[28]

Contrast this now with a corporate division. A division would seem to be the antithesis of continuity (and surely some writers would argue that

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Reorganizations: General Utilities *Hangover*, 72 TAX LAW. 481 (2019). The ability of a corporation to distribute its own stock without tax consequences under I.R.C. § 1032 is beyond the scope of this brief Response.

25. I.R.C. §§ 332, 337 (codifying the general rule for nonrecognition for property distributed to parent in complete liquidation of subsidiary).

26. *See* MCMAHON, JR. ET AL., *supra* note 21, at 409–10. Similar reasoning is given for the section 243 dividends received deduction system. *Id.*

27. The same treatment does not apply if a corporation is 100% owned by an individual; preservation of the double tax system depends on not allowing flesh-and-blood persons to consolidate with paper corporate persons. *See id.* at 20–38.

28. *See id.* at 409–10.

divisions should never be tax free), but one can construct a hypothetical where the division has injected such a low amount of discontinuity that it would be consistent within the corporate taxation context not to require gain recognition (or allow a loss deduction). For example, imagine a corporation with one business that it has conducted for multiple years and two shareholders who have been the only shareholders for multiple years. The corporation moves exactly one-half of the business, transferring a ratable portion of each asset type, to a new subsidiary; after the division of assets, it then distributes the subsidiary stock pro rata to its two shareholders. The corporation and the subsidiary do not alter the configuration of the historic business assets, other than through normal retirements and replacements, and the two shareholders hold on to the stock in both the distributing and controlled corporation for several more years. The discontinuity created by such a spin-off is formal only; the historic business assets are not substantively re-configured; the shareholders have the same level of control over and the same percentage of ownership in the historic business assets; and they maintain these positions well into the future. Not requiring taxation for such a division would be consistent with the current tax system's approach to requiring gain recognition and allowing loss deductions only when continuity is more significantly disrupted.

II. PROFESSOR WELLS'S CONTINUITY PROPOSALS FOR SECTION 355

Professor Wells offers three proposals, all of which add stronger, measurable continuity requirements than those that currently exist. For two of the proposals, Professor Wells suggests that the existing statutory device test could be re-framed through regulations without the need for congressional intervention (although Congress could consider repealing section 355(g) as a result).[29] The third proposal would require statutory amendment—and trigger statutory simplification.[30]

The first regulatory proposal would add a business asset continuity test requiring that, after the division, the majority of assets inside each of the distributing and controlled corporation must be historic business assets. If either the distributing or controlled corporation fails this requirement, the division as a whole would fail the statutory device test and trigger the tax consequences that would normally follow from a corporate distribution. Those typical tax consequences are recognition of gain to the distributing corporation and dividend or sale treatment to the

29. *See* Wells, *supra* note 2, at 495–97.
30. *See id.* at 503–05.

recipient shareholders, depending on the form (e.g., spin-off or split-off) and the availability of earnings and profits.[31]

The second regulatory proposal focuses on the shareholders and the ability to use a corporate division to effect a stock dividend that enhances the proportionate interest of one group of shareholders in the historic business assets. The proposal would require that if either the distributing or controlled corporation contains "excess leverage" following the division, the shareholders of the non-excessively leveraged corporation would have a stock dividend because the concomitant reduction in leverage for that corporation has the effect of increasing the net value of their relationship to the historic assets.[32] Under Professor Wells's proposal, excess leverage would occur if the average debt-to-equity ratio exceeds 120% of the average debt-to-equity ratio that existed for the distributing and controlled corporation before the division.[33]

The third proposal would require statutory changes. It would impose an objective ownership change test that, if violated, would trigger tax on the net unrealized built-in gain for the corporation that had the ownership change, whether that is the distributing or controlled corporation. To measure the ownership change, Professor Wells would incorporate Code section 382, with minor modification. The ownership change would be measured without reference to the division itself, because to do otherwise would mean that a certain type of division (split-offs) could require gain recognition as a matter of course. Professor Wells would impose an evaluation window that would stretch five years prior to and two years following the division and would look for whether the five-year historic shareholders maintained at least fifty percent or more of both the distributing and controlled subsidiary during that period.[34] This proposal limits corporations' ability to transfer value to non-historic shareholders without having the normal tax consequences that would apply in the presence of this hallmark of discontinuity—that is, exchange of property with non-related parties.

In advancing these proposals, Professor Wells engages in a careful examination of congressional history and activity to demonstrate that

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31. *See id.* at 497–99.

32. *See id.* at 501–02.

33. More technically, for the "affiliated group." *Id.* This particular proposal presupposes the ability to distinguish debt from equity. *See, e.g.*, William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000).

34. Wells, *supra* note 2, at 505.

section 355 and the related regulations do not correctly implement Congress's intended boundary between sufficient continuity and significant discontinuity for corporate divisions. Because continuity is a pragmatic concept rather than part of the normative income tax, relying on congressional intent to determine the requisite level of continuity is understandable, but there are also potential drawbacks with such reliance because congressional intent may be difficult to discern,[35] may change over time, or may lack consistency across related areas.

For example, a divisive type (D) reorganization is a common feature in a corporate division; that provision allows corporations to move historic assets to a controlled subsidiary in preparation for the subsequent distribution of the controlled subsidiary.[36] In 1998, Congress amended Code section 368(a)(2)(H)(ii) to provide that in determining whether a valid divisive type (D) has occurred, "the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account."[37] This provision could be interpreted to suggest Congress intends that ownership changes following the division should not affect eligibility for non-recognition.[38] Such a reading suggests that Professor Wells's proposal may be stricter than Congress would desire. At the same time, section 351 and section 332 require a much higher continuity threshold and could suggest that requiring a higher percentage of ownership or asset continuity for nonrecognition than that proposed by Professor Wells could also be viewed as consistent with other aspects of Subchapter C.

This is not at all to suggest that Professor Wells has the balance wrong; indeed, his proposals would substantially improve section 355 while being attentive to the practical likelihood of implementation given the trends in congressional and regulatory intent in this area. It is rather to highlight the tensions inherent in relying on congressional intent; at the same time, it must be acknowledged that the continuity concept is not normative bedrock. Still, some continuity thresholds are closer to the mark-to-market ideal than others, and certainly, the

35. *See* Charlene D. Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW. 551, 556 & n.20 (2013).

36. *See* I.R.C. § 368(a)(1)(D) (2012) (codifying type (D) reorganizations); *see also* Herbert N. Beller, *Section 355 Revisited: Time for a Major Overhaul?*, 72 TAX LAW. 131, 136–37 (2018) (referring to "divisive" nature of type (D) reorganizations).

37. I.R.C. § 368(a)(2)(H)(ii), *as amended by* Pub. L. 105-277, § 4003(f)(2), 112 Stat. 2681, 2681-909 to 910 (1998), *and* Pub. L. 105-206, § 6010(c)(3)(B), 112 Stat. 685, 812–14 (1998).

38. *See* MCMAHON, JR. ET AL., *supra* note 21, at 797–98 & n.12.

thresholds in current section 355 are far from satisfactory. In other words, Professor Wells could find further support for his reform proposals by invoking, separately from congressional intent, the continuity concept and its relationship to the normative income tax.

CONCLUDING THOUGHTS

The foregoing has focused on Professor Wells's primary contribution, which is the emphasis in *Reform of Section 355* on the importance of requiring the presence of specific measures of continuity for tax deferral on a corporate division, but Professor Wells offers at least two significant additional contributions. First, he draws attention to the fact that various corporate tax provisions have not been simplified in reaction to the change in the taxation rate of dividends for individuals, even though that rate change has been in place since 2003 and formally made permanent in 2013.[39] Reframing the device test toward continuity and away from a focus on the bailout of earnings and profits provides an example of the simplification proposals that are possible given the much closer equivalence of dividends and long-term capital gains. Second, as alluded to above, Professor Wells offers a meticulously researched historical account of *General Utilities* repeal and the changes to section 355. This narrative will be an invaluable resource to future tax scholars writing in the corporate tax area.

Reform of Section 355 offers proposals that both strengthen and simplify the tax rules governing corporate divisions. Reliance on the continuity concept is an inherently pragmatic choice given the messy reality of income taxation in general and corporate income taxation in particular, but, as Professor Wells demonstrates, that does not mean continuity is a concept unable to provide an effective framework for objective reform. Use of the continuity concept allows for meaningful evaluation of a proposal's proximity to the normative income tax and of a proposal's merits relative to existing law or to competing proposals. The proposals advanced by Professor Wells are not only consistent with congressional intent but also move the tax treatment of corporate divisions incrementally closer to an ideal income tax.

39. *See* Wells, *supra* note 2, at 463 & n.53.