BYU Law Review

Volume 1982 | Issue 1 Article 2

3-1-1982

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Recommended Citation

Robert D. Crockett, *The Corporate Acquisitions Proposal of the ALI Subchapter C Project: Correcting Economic Inefficiencies by Election*, 1982 BYU L. Rev. 134 (1982).
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The Corporate Acquisitions Proposal of the ALI Subchapter C Project: Correcting Economic Inefficiencies by Election

In 1977 members of the American Law Institute (ALI) approved Tentative Draft No. 1[1] of the subchapter C study, which proposes a restructuring of the corporate acquisitions[2] rules under the existing Internal Revenue Code and Treasury Regulations. The Tentative Draft proposals, if adopted, would allow a transferor corporation to elect nonrecognition (the transferee taking carryover-basis) or recognition (the transferee taking cost-basis) of gain or loss in either a stock or assets acquisition.[3] The Reporter, Professor William Andrews, considered the proposals of the subchapter C project necessary to simplify the ex-

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1. FED. INCOME TAX PROJECT (Tent. Draft No. 1, 1977) (subchapter C: corporate acquisitions) [hereinafter cited as T.D. No. 1]. The project has also produced the following drafts: FED. INCOME TAX PROJECT (Tent. Draft No. 2, 1979) (subchapter C: corporate distributions); FED. INCOME TAX PROJECT (Tent. Draft No. 3, 1979) (subchapter K); FED. INCOME TAX PROJECT (Tent. Draft No. 4, 1980) (subchapter K); FED. INCOME TAX PROJECT (Tent. Draft No. 5, 1980) (subchapter C: corporate acquisitions—specifically, special limitations on loss carryovers and parent stock held by a subsidiary) [hereinafter cited as T.D. No. 5]; FED. INCOME TAX PROJECT (Tent. Draft No. 6, 1981) (subchapter J); FED. INCOME TAX PROJECT (Tent Draft No. 7, 1981) (subchapter K). Only T.D. No. 1 and T.D. No. 5 are the subjects of this Comment. The acquisition proposals have been reproduced in Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions,* 33 TAX LAW. 743, 775-83 (1980), and Wolfman, *"Continuity of Interest" and the American Law Institute Study,* 57 TAXES 840, 843-46 (1979).

For a background of the subchapter C proposals, see Beghe, *supra,* at 774-88. The Reporter's summary of the subchapter C proposals, their goals, and likelihood of adoption may be found in T.D. No. 5, *supra,* at 5-8.

2. The term "acquisition" will be used loosely in this Comment to include asset and stock acquisitions, and section 368 reorganizations. The Reporter maintains that the existing "reorganization definition is almost senselessly complicated in the variety of different criteria it imposes for reorganization treatment of different forms of transactions." T.D. No. 1, *supra* note 1, at 28. He believes that a more functional definition exists. *Id.* at 35-40. This Comment is addressed to such a definition. Under the proposals, "acquisition" is limited and refers to

> transaction[s] between unrelated corporate parties and does not include transactions in which the shareholders of the acquired corporation control the acquiring corporation. . . . The term also refers primarily to acquisitions of all the stock or all the assets of an acquired corporation which was not previously a subsidiary of any other corporation.

Id. at 49-50 (Proposal IIA); T.D. No. 5, *supra* note 1, at 159 (Proposal IIA).

3. T.D. No. 1, *supra* note 1, at 14-15. *See also infra* notes 7-27 and accompanying text.

isting rules.[4] In 1980 the Reporter submitted a revised version of the proposals, Tentative Draft No. 5,[5] which contained loss carryover and subsidiary holdings refinements to the earlier draft. To date, the analytical discussion of the drafts in the literature has been limited but favorable.[6]

This Comment will first introduce the ALI proposals, including the concept of an explicit election. The existing tax rules will then be applied against the traditional economic objective of efficiency employing two important criteria—tax neutrality and administrative efficiency—to demonstrate the extent to which the objective of economic efficiency is violated by the existing rules. Finally, the discussion will return to an analysis of the ALI proposals to suggest that there would be probable improvement in economic efficiency should the proposals be adopted. This improvement in economic efficiency outweighs possible objections to the proposals.

I. Summary of the ALI's Proposed Election Mechanism

A. *Mechanics of the Proposals*

The Tentative Drafts of the ALI proposals permit corporate parties to an acquisition to expressly or implicitly elect between nonrecognition or recognition of gain or loss in either a stock or assets acquisition. This permits parties to structure a sale or disposition of assets or stock in the manner they wish and then elect between the following general rules when applicable:

> (1) the transferee acquires assets on cost-basis and the transferor recognizes gain or loss on the transfer;[7]
> (2) the transferee acquires stock on cost-basis by explicit election (provided an eighty percent control requirement is met), treating the transfer as if the acquired corporation transferred its assets and distributed the proceeds in liquidation to its shareholders, causing the acquired corporation to be liable for

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4. 54 A.L.I. Proc. 314-15 (1977) (May 19, 1977 morning session, remarks of William D. Andrews).

5. T.D. No. 5, *supra* note 1. *See supra* note 1.

6. Beghe, *supra* note 1, *passim;* Ginsburg, *Collapsible Corporations—Revisiting an Old Misfortune,* 33 Tax L. Rev. 309, 325-28 (1978); Wolfman, *supra* note 1, *passim.*

Renato Beghe believes that the proposals "have anticipated almost every objection that might be made [and] contain no mechanical flaws that cannot be easily corrected." Beghe, *supra* note 1, at 774. "[T]he Drafts offer a thorough and thoughtful revision of the tax law and practice . . . ." *Id.* at 770.

7. T.D. No. 1, *supra* note 1, at 122-23 (Proposal IVA); T.D. No. 5, *supra* note 1, at 162-63 (Proposal IVA).

the tax;[8]
(3) the transferee acquires assets on a carryover-basis by explicit election and the transferor corporation recognizes gain or loss if it liquidates or meets other conditions;[9]
(4) the transferee acquires stock on a carryover-basis with the acquired corporation recognizing no gain, the transferee retaining the acquired corporation's basis in the assets, and the transferring shareholders being taxed as usual.[10]

An asset acquisition is presumed by the proposals to be cost-basis unless an explicit election is made. A stock acquisition is presumed by the proposals to be carryover-basis (referring to the basis in the assets) unless an explicit election is made.[11]

The distinction between the existing rules and the Tentative Draft proposals may be illustrated by the following example.[12] Suppose a corporation purchases all of the stock of an unrelated corporation for $1000. The acquired corporation has a $600 basis in its assets, which have a fair market value of $1000. The acquired corporation has no liabilities.

Under existing tax rules, the acquiring corporation has a basis of $1000 in the stock. The acquired corporation recognizes no gain or loss on the exchange. If the acquiring corporation liquidates the newly acquired corporation under section 334, the basis in the assets is stepped up to $1000 without the acquiring corporation having to recognize gain.

Under the ALI proposals, a purchase of stock is presumptively treated as a carryover-basis acquisition which, however, may be electively treated as a cost-basis purchase.[13] With carryover-basis treatment, the acquiring corporation's basis in the stock is $600. Under the proposals that basis is derived from the net aggregate basis for the acquired corporation's assets.[14]

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8. T.D. No. 1, *supra* note 1, at 151 (Proposal IVE-2); T.D. No. 5, *supra* note 1, at 165 (Proposal IVE-2).

9. T.D. No. 1, *supra* note 1, at 82-83 (Proposal IIIA); T.D. No. 5, *supra* note 1, at 160-61 (Proposal IIIA).

10. T.D. No. 1, *supra* note 1, at 70-71 (Proposal IIB); T.D. No. 5, *supra* note 1, at 159-60 (Proposal IIB). *See also* Beghe, *supra* note 1, at 753-54.

11. T.D. No. 1, *supra* note 1, at 47-50.

12. In addition to the asset purchase example, Beghe discusses the stock purchase, purchase premium, unallocated premium for goodwill, assets for stock, stock for stock, hybrid transactions, and triangular reorganizations. Beghe, *supra* note 1, at 749-62.

13. T.D. No. 1, *supra* note 1, at 49-50 (Proposal IIA); T.D. No. 5, *supra* note 1, at 159 (Proposal IIA).

14. T.D. No. 1, *supra* note 1, at 70-71 (Proposal IIB); T.D. No. 5, *supra* note 1, at 160-61 (Proposal IIB). The proposals seek to fix "the basis for determining gain or loss

If cost-basis treatment is elected under the proposals, the transaction is treated as if the acquiring corporation has purchased the acquired corporation's assets for cash and then liquidated the newly acquired subsidiary.[15] The basis in the assets is stepped up to $1000, and the acquiring corporation must recognize the $400 gain.

The preceding example deals with a simple stock acquisition; a similar election by an acquiring corporation in an asset acquisition is slightly more complex. Under the proposals, the selling corporation must consent to an election of cost-basis treatment by the acquiring corporation[16] because such an election forces the selling corporation to recognize gain or loss. Such consent is not required of a selling party in a stock acquisition because Proposal IVE of the Tentative Drafts treats the transaction as if the new subsidiary had transferred its assets to the parent and distributed the proceeds to the parent. The parent—the acquiring corporation—must then pay the taxes arising from this imputed asset transfer. The new subsidiary, therefore, has a fresh cost basis in the assets.[17]

B. *Stated Advantages of the Proposals*

Two advantages stand out among those stated by the Reporter. First, the proposals seek to preserve the integrity of the corporate income tax by restricting the opportunity that exists under current law to step up the basis of an asset without paying corporate income tax. This step-up in basis is accomplished under the existing rules by distribution in kind or a preliquidation sale[18] according to the rule promulgated in *General Utilities & Operating Co. v. Helvering.*[19] The Reporter criticizes this rule, now codified in section 334, which permits a corporation to realize no gain from the distribution of appreciated property.[20]

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on a transfer of subsidiary shares by reference to the subsidiary's asset basis." T.D. No. 1, *supra* note 1, at 58.

15. T.D. No. 1, *supra* note 1, at 151 (Proposal IVE-2); T.D. No. 5, *supra* note 1, at 165 (Proposal IVE-2).

16. T.D. No. 1, *supra* note 1, at 152 (Proposal IVE-2); T.D. No. 5, *supra* note 1, at 165 (Proposal IVE-2).

17. T.D. No. 1, *supra* note 1, at 152 (Proposal IVE-2); T.D. No. 5, *supra* note 1, at 165 (Proposal IVE-2).

18. I.R.C. §§ 334(b)(2), 337 (1976 & Supp. III 1979). *See also* Beghe, *supra* note 1, at 748; T.D. No. 1, *supra* note 1, at 21.

19. 296 U.S. 200 (1935).

20. T.D. No. 1, *supra* note 1, at 109.

Proposal IVA would repeal this rule and its "illegitimate offspring"—the section 341 collapsible corporation,[21] with its "pathological"[22] complexity, vagueness, and uncertainty.[23] Proposal IVA would require recognition of gain or loss on corporate transfers of assets realized by distribution in kind to shareholders or by sale in the course of liquidation, in which basis does not carry over.[24]

Second, the proposals seek to simplify and explicitly provide for what is effectively available under the existing rules. The Reporter complains that the existing acquisition rules are ambivalent about the actual existence of elections.[25] As an example, the Reporter refers to the effective election available under section 334(b)(2). This section permits a corporation to treat a stock purchase, ordinarily resulting in a carryover-basis of the assets, as an indirect purchase of the assets. This result is accomplished by complying with certain technical rules, such as liquidation within two-years. The effect of the indirect purchase of the assets is to spread the basis of the liquidated stock over the assets. The stock purchase is therefore given cost-basis treatment when the taxpayer jumps the necessary hurdles posed by the technicalities of the rules.[26] It is unclear, however, whether the formalisms were adopted to provide the taxpayer with a clear choice between cost and carryover basis alternatives.[27] The proposals seek to eliminate this ambivalence.

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21. Ginsburg, *supra* note 6, at 322. For a comprehensive discussion of the collapsible corporation, see Ginsburg's entire article.

22. T.D. No. 1, *supra* note 1, at 116.

23. "This proposal has the great advantage of making it possible to eliminate the collapsible corporation provision." *Id.* at 18.

24. *Id.* at 122-23 (Proposal IVA); T.D. No. 5, *supra* note 1, at 162-63 (Proposal IVA).

25. T.D. No. 1, *supra* note 1, at 31-33.

26. *Id.* at 31. *See* I.R.C. § 334(b)(2)(A), (B) (1976).

27. In American Potash & Chemical Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968), the Court of Claims permitted a stock purchase to be treated as an indirect asset purchase even though the transaction did not comply with the technicalities of § 334(b). The Reporter notes that the Court of Claims found that § 334(b) did not necessarily give a taxpayer an election between cost- and carryover-basis. Cost-basis, according to the court, may be had if the proper intent was found, despite § 334(b)'s apparent exclusivity. T.D. No. 1, *supra* note 1, at 32. Thus, the effective election was, according to the court, no election at all.

II. The Existing Corporate Acquisition Rules and Economic Inefficiency

Corporate parties must strictly adhere to statutory formalisms under the existing rules to reach desired results through effective election. These statutory formalisms are detrimental to corporate financial policy and the economic markets in which the corporation is a participant. Economic efficiency, defined as the optimal allocation of resources, is degraded when the tax rules intrude on the corporate decisionmaking process. Furthermore, the complexity of the rules diminishes economic efficiency by inducing corporate parties to channel funds into the unproductive activities of tax computation and the determination of tax-minimizing courses of action. These degradations compound the already deleterious effects of the corporate income tax, which by its very imposition leads to fundamental inefficiencies.

The tax policy analyst must acknowledge and wrestle with the varied and somewhat competing objectives in tax policy to arrive at some "tax-optimal" conclusion. These objectives include the need to (1) raise revenue (the revenue maximization incentive), (2) encourage economic growth and efficiency, (3) redistribute income and wealth, (4) achieve equitable treatment of the individual taxpayer by the government in taxation and distribution, (5) encourage national priorities, (6) encourage certain industrial development, (7) prohibit or encourage certain conduct, and (8) fulfill politically motivated goals.[28] Of course, a given tax may not be able to reach all of these objectives concurrently. The equity objective, for example, may be subordinated to the revenue maximization objective in progressive tax schemes.

A major consideration in evaluating the optimality of a tax is economic efficiency. This objective asks whether the tax and its allowances inhibit or promote the efficient allocation of resources.[29] Policymakers, however, should not always consider the

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28. Crumbley, *Behavioral Implications of Taxation*, 48 Acct. Rev. 759, 759 (1973). *See also* Ture, *Federal Income Tax Rates, Incentives, and Equities*, in Essays On Taxation 20 (1974).

29. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 San Diego L. Rev. 735, 736 (1979). Professor Bittker discusses the current debate between "equity" and "efficiency" tax theorists over tax allowances that may impose different tax burdens on taxpayers. He concludes the normative standards favored under either theory cannot be applied with confidence to existing law while the behavioral consequences are unknown. *Id.* at 748. Because the article deals principally with determining the propriety of allowances, the debate is not an issue in this Com-

efficiency objective to be supreme over all others. Equitable and political considerations can and often do conflict with the economic efficiency objective. The socialist would argue, for example, that high economic efficiency falls hardest on the poor.[30] The politician may argue that a particular policy of heavy industry protectionism in anticipation of war would benefit national interests to a greater degree than the amount of lost efficiency. Therefore, burdens on the market may occur when policymakers intentionally sacrifice elements of efficiency for national interest. On the other hand, special interest legislation and regulation may unintentionally degrade efficiency. A knowledge of the economic inefficiencies of a particular tax is an essential ingredient of successful macroeconomic policy.[31] This knowledge must be applied against competing policy objectives. This analysis casts a shadow on the perpetuation of existing corporate acquisition rules when, as this Comment suggests, better alternatives may be found in the ALI proposals.

A. *The General Effect of a Corporate Income Tax*

1. *The effect of taxation on corporate policy*

Although economists, businessmen, and lawyers disagree over the probable incidence[32] of corporate taxation, most admit that the corporate tax influences corporate behavior[33] and economic markets where the corporation is a participant. The corporation may treat the tax as a "cost" in its price, output, and investment decisions[34] and as such, seek to minimize the tax whenever possible. The incentive to minimize taxes will lead to alternative courses of action when available, and the reality of

ment, which is concerned with procedure and procedural interferences.

30. C. ALLAN, THE THEORY OF TAXATION 174, 182 (1971).

31. *Id.* at 78.

32. "Incidence" refers to the question of on whom the tax actually falls—the shareholder in terms of lower profits, the corporation's "end" consumer in the form of higher prices, the worker in the form of lower wages, the executive in the form of lower salaries, the corporation's supplier in the form of lower prices, or some combination of these. *See generally* W. ANDERSON, TAXATION AND THE AMERICAN ECONOMY 303-10 (1951); J. PECHMAN, FEDERAL TAX POLICY 111-23 (rev. ed. 1971); A. PREST, PUBLIC FINANCE 359-61 (5th ed. 1975); D. SMITH, EFFECTS OF TAXATION (1952); Chapman, *The American Tax Structure—A Business View,* in ESSAYS ON TAXATION 9, 13 (1974); Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics,* 1965 WIS. L. REV. 576; Marberry, *On the Burden of the Corporate-Income Tax,* 11 NAT'L TAX J. 323, 323 (1958).

33. *See, e.g.,* D. SMITH, *supra* note 32.

34. Marberry, *supra* note 32, at 303.

tax as a "cost" will lead to decreased output and the disappearance of marginal producers.[35] The incentive, therefore, to minimize the tax burden affects corporate financial policy, and the reality of tax as a "cost" affects market mechanisms.

2. *General difficulties with the corporate tax*

The theoretical basis for the corporate income tax, which relies on the fiction of the separateness of the corporation and the shareholders, has suffered much criticism. The tax narrows the differential between efficient and inefficient corporations by taxing profitable corporations relatively heavily and taxing unprofitable corporations lightly or not at all.[36] Because the differential between efficient and inefficient corporations is reduced, it is probable that the investor will direct his funds into a suboptimal allocation of resources.[37] The various individual rules that comprise the corporate income tax should not be arbitrarily inefficient; otherwise the deleterious effects of the general corporate income tax on market workings would be greater than necessary.[38]

B. *Specific Violations of the Economic Efficiency Objective Under the Existing Rules*

The existing rules violate the economic efficiency objective. Several criteria are traditionally employed by theorists to judge the desirability of behavioral and economic effects on market operation and on the corporate taxpayer. Two of these efficiency criteria are not met under the existing acquisition rules. These are (1) tax "neutrality," pertaining to the avoidance of arbitrary coercion, and (2) "administrative" efficiency, pertaining to

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35. This is true under "traditional" economic theory. W. ANDERSON, *supra* note 32, at 303. It may not necessarily be true under other economic theories. *Id.* at 304-07.

36. C. ALLAN, *supra* note 30, at 166.

37. *Id. See also* Chapman, *supra* note 32.

38. The acquisition rules under the existing tax rules, however, may be unreasonable extensions of this corporate fiction. According to Henry Simons,

> [a]ll corporation tax procedure is infested with or rested upon the fiction, elsewhere often useful, that corporations may properly be treated as or like natural persons. The fiction becomes obviously silly when these "persons" are merged, affiliated, or suddenly reincarnated in new adult forms, and the whole foundation or rationale of procedure (which was really never there at all) seems suddenly to drop away.

Simons, *Federal Tax Reform,* 14 U. CHI. L. REV. 20, 33 (1946). *See also* Bittker, *Reflections on Tax Reform,* 47 U. CIN. L. REV. 185, 192 (1978).

simplicity.[39]

1. Problems with the tax neutrality criterion under the existing rules

The existing rules fail to meet the tax neutrality criterion of economic efficiency. The neutrality criterion seeks to minimize the intrusion of a tax on corporate and individual marketplace decisions.[40] The existing rules, although effectively elective, require the corporate taxpayer to strictly adhere to code-defined corporate procedure. This requirement intrudes on the corporate decisionmaking process by arbitrarily limiting free electivity when tax and normal corporate procedures conflict.[41]

An intrusion of the tax into the decisionmaking process distorts market mechanisms.[42] According to Professor Simons, "[i]t is the business for enterprises to produce goods and to make money."[43] Once necessary rules of corporate enterprise are given (such as antitrust or contract law), corporations "should be free from arbitrary influences of taxes in their actions and crucial decisions."[44] The public economic good is particularly benefited when the corporation is unfettered in decisions pertaining to production, price, and investment.[45]

Richard Posner points out that, as a practical matter, "[t]he imposition of a tax on an activity creates an incentive for [the taxpayer] engaged in the activity to substitute another activity that is taxed less heavily."[46] This results in what is known in

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39. Other criteria, some of which may also be related to noneconomic objectives, require that taxes be "vertically" and "horizontally" equitable, C. ALLAN, *supra* note 30, at 36-37, and simple to comprehend and administer. *See generally* W. ANDERSON, *supra* note 32, at 50-94; C. ALLAN, *supra* note 30; Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979); Blum, *Corporate Acquisitions Under the Income Tax: Another Approach,* 50 TAXES 85 (1972); Stiglitz & Boskin, *Impact of Recent Developments in Public Finance Theory on Public Policy Decisions,* 67 AM. ECON. REV. PAPERS & PROC. 295 (1977); Ture, *supra* note 28, at 20. Like the various tax policy objectives, the various economic efficiency criteria may compete with one another and require certain trade-offs if one is preferred over another. Stiglitz & Boskin, *supra,* at 296. For example, tax rulemakers may decide that a complex scheme to achieve vertical and horizontal equity is more important than simplicity.

40. W. ANDERSON, *supra* note 32, at 54; Ture, *supra* note 28, at 20.

41. T.D. No. 1, *supra* note 1, at 47.

42. C. ALLAN, *supra* note 30, at 37.

43. Simons, *supra* note 38, at 57.

44. *Id.*

45. *Id.*

46. R. POSNER, ECONOMIC ANALYSIS OF LAW § 17.1 (2d ed. 1977).

economic discussions as "second-best" selection. "Presumably . . . [the taxpayer was] more productively employed in the first activity . . . ; hence the tax has reduced the efficiency with which resources are being employed."[47]

This second-best selection has negative implications because it creates an "excess burden" on the corporate markets and their mechanisms—the very evil the neutrality criterion seeks to avoid. When taxes are not neutral among alternatives, the second-best selection results in a suboptimal allocation of resources. A suboptimal allocation amounts to a cost to the taxpayer and to the government that is greater than any additional government receipts hoped to be gained from the nonneutral tax policy. The cost is greater than the additional receipts because potential receipts are consumed by opportunity costs and increased administrative expenses. The combined loss, not reflected in tax revenues, constitutes the excess burden.[48]

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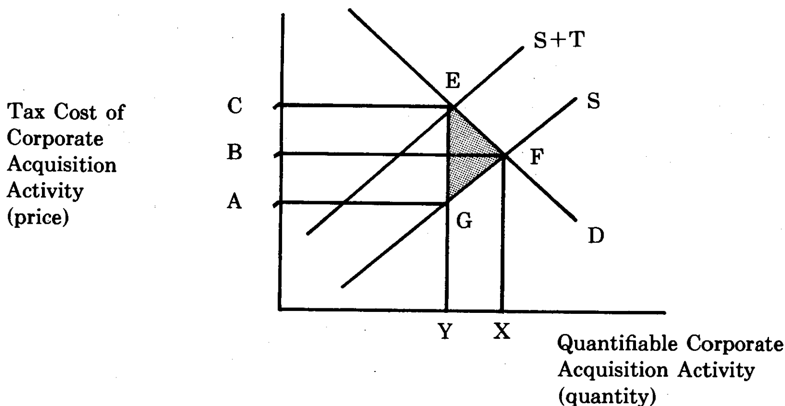
47. *Id.*

48. Harriss, *Taxation of Business: Fundamental Issues,* in ESSAYS ON TAXATION 35, 38 (1974).

The excess burden may be represented in simplest fashion by using the Marshallian cardinal utility approach. C. ALLAN, *supra* note 30, at 81-83.



The graph may be thought of as representing corporate activity and tax constraints by the government. It should be assumed that the corporate sector seeks to maximize desirable activity and that the government, on the other hand, seeks to maximize revenue. The quantity side represents the quantiable corporate activity—for example, the number of times the corporate sector may seek desirable mergers. The price represents the tax cost to the corporate sector of engaging in a particular corporate activity. For purposes of simplicity, this Comment will assume that such a curve slopes downward. The demand curve represents the willingness of the corporate sector to engage in the desirable corporate activity, depending on the cost; for example, the corporate sector would be inclined to pursue favorable mergers more often if the tax cost were lower than if the tax cost were higher.

Complete neutrality is perhaps impossible in the corporate markets. Economists, therefore, do not speak in terms of elimination of the excess burden. They refer only to its minimization.[49] An example of a minimally intrusive tax is a general sales tax. A general sales tax achieves a high degree of neutrality because "all goods are made dearer so there is no reason for irrational reallocation of [resources]."[50] The merchant, however, would occasionally lose the revenue from the would-be purchaser who cannot pay the fraction of the cost of the good represented by the tax. This occasional loss constitutes at least a portion of the minimal excess burden.[51]

Second-best selection arises under the existing rules because of conflicts between code-dictated procedure and the procedure the corporation would ordinarily follow if the acquisition rules did not exist. The Reporter feels the conflict is serious because "tax classification depends on taking particular corporate procedural steps, which may sometimes be impossible or inconvenient for nontax reasons."[52] Four examples may be employed to

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Conversely, the supply curve may simply be thought of as representing the government's willingness to tax corporate activity; due to revenue maximization motives, the government would find attraction in taxing popular corporate activity.

The equilibrium tax price would be located at B and the quantifiable corporate activity would stablize at X.

Suppose, however, the government decides to impose an additional tax of EG on the activity. The supply curve would shift to S + T. Tax cost to the corporation would rise from B to C; corporate activity would fall from X to Y. New revenue to the government would therefore be represented by box ACEG, or new tax rate EG times new quantity AG. The cost to the corporation, however, is represented by BCEF, or loss of "consumer surplus" (in this case consumer surplus may be thought of as the unused potential for corporate taxation). The "cost" to the government by way of lost revenues from the quantity shift is ABFG. Therefore, the total loss to both the government and the corporation is the five-sided figure ACEFG. Since the government has realized an incremental benefit of only ACEG, the loss to both exceeds the gain—as represented by the shaded portion.

Furthermore, "for a given revenue the loss of surplus [increased excess burden] will be larger [if the elasticity for either demand or supply is larger]; if either is completely inelastic the loss of surplus falls to zero . . .; in all ordinary circumstances, however, there will be some loss of surplus." U. HICKS, PUBLIC FINANCE 149 (3d ed. 1968). *See id.* at 146-50. *See also* C. ALLAN, *supra* note 30, at 37-38.

49. C. ALLAN, *supra* note 30, at 38; W. ANDERSON, *supra* note 32, at 54; Simons, *supra* note 38, at 57.

50. C. ALLAN, *supra* note 30, at 38. However, because the general sales tax is regressive, falling harder on the poor, it fails the criterion of equity. *See id.* at 36-37.

51. In a purely competitive market, however, all purchasers would drop out if substitutes could be found. Conversely, if the demand for consumer goods is inelastic, no purchasers would drop out. *See* U. HICKS, *supra* note 48, at 146-50.

52. T.D. No. 1, *supra* note 1, at 34.

demonstrate the second-best selection and the presence of excess burdens under the existing acquisition rules. These examples deal with stock purchase versus asset purchase decisions, indirect asset purchases, carryover-basis transfers of less than substantially all the assets of a corporate transferor, and certain sales of highly profitable capital assets.

a. Stock versus asset purchase decisions.[53] Suppose a corporation wishes to acquire all the assets of another corporation. Suppose further that minority shareholders of the target corporation object to the sale and seek to block it. The directors of the target corporation, on the other hand, are favorable to the sale. The acquiring corporation usually has two obvious choices if it truly wishes to acquire the assets: it may purchase the assets outright, or it may purchase the stock of the corporation and either use the assets through the subsidiary shell or distribute them in liquidation. In this example, the acquiring corporation would normally wish to purchase the assets outright to avoid dealing with many shareholders.

Under existing acquisition rules, however, the tax consequences are likely to induce a stock purchase instead. With an asset purchase the target corporation must recognize depreciation and investment credit recapture gain.[54] With a stock purchase neither the acquiring corporation nor the target corporation recognizes gain or loss. The basis in the assets is carried over in a stock sale. Given no problems with boot or collapsible corporations, the purchaser would be more inclined to purchase stock if appreciated assets are involved.[55]

If the directors of the corporation are persuaded by the tax consequences to acquire by stock purchase, the corporation will probably incur real losses. These losses may include expenses necessary to contact all shareholders, deal with obstructionist stockholders in litigation or purchase premiums, or meet federal and state securities filing requirements.

The government also incurs losses by creating a rule that

53. *Id.* at 34-35.

54. I.R.C. §§ 1245, 1250 (1976 & Supp. III 1979).

55. Admittedly, § 334(b)(2) tends to ameliorate the conflict by treating an acquisition as an asset purchase even though shares of stock originally traded hands. Also, the reorganization provisions under § 368 make it possible to treat an asset purchase as a stock acquisition. However, the Reporter is quick to point out that compliance with these sections "may itself involve taking steps or meeting conditions that are impossible or inconvenient, and so the possibility of conflict continues." T.D. No. 1, *supra* note 1, at 34-35.

intrudes on the corporate decisionmaking process. The corporation, required to make more expenditures, has less taxable income. The government, therefore, receives less revenue. Moreover, the recognition requirement of cost-basis asset acquisitions would induce the corporation to make fewer desirable acquisitions, thereby reducing the current tax liability and corresponding government receipts.

In this example, the combined loss to the government and the corporate taxpayer constitutes the excess burden. The losses go neither to corporate nor government coffers. Instead, the market experiences a suboptimal allocation of resources.

b. Indirect asset purchases. Suppose a corporation wishes to purchase the outstanding stock of another corporation and step up the basis in the underlying assets to the cost of the stock. Existing rules permit the acquiring corporation to treat this transaction as an indirect purchase of the assets only if the purchase is followed by liquidation of the acquired corporation.[56]

Under section 334(b)(2), if a distribution is made "pursuant to a plan of liquidation adopted not more than 2 years"[57] after the acquisition and eighty percent of the stock of the acquired corporation is acquired by purchase within a twelve-month period,[58] "the basis of the property in the hands of the distributee shall be the adjusted basis" of the acquired stock.[59] The Reporter in Tentative Draft No. 1 discusses the problems with this rule[60] and criticizes the required liquidation of an acquired corporation as a condition for cost-basis treatment.[61]

The requirement of an often unnecessary liquidation violates the neutrality criterion. The acquiring corporation, which may have desired to carry on the business of the target corporation, cannot easily do so in subsidiary form but must liquidate the target corporation into the acquiring corporation. This intrusion into corporate policy may result in real losses. First, it may induce the would-be acquiring corporation to forego the otherwise advantageous acquisition. This second-best selection may therefore result in lost profits and lost taxable income for the government where the merger would result in greater efficien-

56. *Id.* at 142.
57. I.R.C. § 334(b)(2)(A) (1976).
58. I.R.C. § 334(b)(2)(B) (1976).
59. I.R.C. § 334(b)(2) (1976).
60. T.D. No. 1, *supra* note 1, at 143-44.
61. *Id.* at 145.

cies. Second, should the acquisition be completed, the acquiring corporation must incur additional expenses to effectually circumvent the rule if it wants to operate with the assets in subsidiary form. Third, if the corporation accedes to the pressure not to operate in subsidiary form, it loses the opportunity to avail itself of the advantages of separate corporate liability or separate section 105 accident and health plans.

The combined loss to the government and the corporation with the requirement of liquidation is the excess burden. The expenses and losses which inure neither to the government nor the corporation, result from a second-best allocation of resources.

c. *Carryover-basis transfers of less than substantially all the assets of a corporate transferor.*[62] Suppose a corporation wishes a carryover-basis transfer of some, but less than "substantially all,"[63] of its assets. Existing rules discourage such a transfer if the assets are not held entirely in a preexisting subsidiary.[64] If the assets are substantially all the assets of a subsidiary, recognition of gain may be avoided by reorganization under sections 361 and 368 or by distribution in kind of the subsidiary shares followed later by a sale of the undistributed shares to an unrelated purchaser (spin-off).[65] If the sale does not qualify as a "reorganization" under section 368, the selling corporation may avoid gain or loss if it adopts a plan of complete liquidation under section 337.[66]

The rules induce the corporation to hold assets in subsidiaries or to spin off subsidiary shares in anticipation of sale of less than substantially all of its assets. The neutrality criterion is violated by inducing the corporation to create subsidiaries and engage in otherwise fruitless distributions or liquidations. The subsidiary maintenance and distribution costs would constitute real losses for the parent corporation. These losses would form at least a portion of the excess burden.

d. *Sales of highly profitable capital assets.* Suppose a corporation wishes to sell some highly profitable capital assets, but

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62. *See id.* at 95-104.

63. "Substantially all" of the assets of a corporation must be transferred to receive tax-free consideration under I.R.C. § 368(a)(1)(C) (1976).

64. T.D. No. 1, *supra* note 1, at 96-97.

65. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.01-.03 (4th ed. 1979).

66. T.D. No. 1, *supra* note 1, at 96.

the corporate tax rate is generally higher than the effective rates of the shareholders. Under section 337(a), the corporation can make the sale yet recognize no gain or loss at its higher tax rate if it adopts a plan of liquidation and within a twelve-month period following that adoption distributes all the assets.[67]

The neutrality criterion is violated when the rules induce the corporation to liquidate rather than continue in operation. According to the Reporter, "[c]omplete elimination of corporate tax creates too large a discrepancy in favor of selling out or distribution as compared with continuing in business."[68] Although the shareholders may be subject to taxable gains or losses on the liquidation,[69] they will experience economic loss because they chose to dissolve the entity: the potential for income producing activities under the original corporation is eliminated in favor of some second-best alternative. An attempt by the shareholders to reincorporate may run into "complete liquidation"[70] problems; the shareholders must either discontinue doing business in the same corporate form or incur substantial advisory costs to determine that complete liquidation has been effected.

This example is further complicated by the collapsible corporation problem.[71] If the corporation is considered collapsible, it is subject to the shareholder punitive provisions of section 341 and denied nonrecognition treatment at the corporate level in a section 337 preliquidation sale. The corporation, however, may escape the recognition problem by foregoing a preliquidation sale and instead distributing the assets in liquidation.[72] There may be economic losses if the corporation foregoes the intended sale. Timing risks and increased transaction costs to effect a dis-

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67. B. Bittker & J. Eustice, *supra* note 65, ¶ 11.64, at 11-70.

68. However, the Reporter maintains that the two taxes cannot be considered complementary. T.D. No. 1, *supra* note 1, at 117.

69. *Id.*

70. I.R.C. § 334(b) (1976). *See* B. Bittker & J. Eustice, *supra* note 65, ¶ 11.45, at 11-54.

71. A corporation is considered collapsible if it has been formed or availed of principally for the manufacture, construction, or production of property . . . with a view to—

> (A) the sale or exchange of stock by shareholders (whether in liquidation or otherwise) . . . before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.

I.R.C. § 341(b) (1976).

72. B. Bittker & J. Eustice, *supra* note 65, ¶ 11.66, at 11-88; T.D. No. 1, *supra* note 1, at 115.

tribution-then-sale are real losses incurred by shareholders. The possibility of such losses may discourage an otherwise profitable sale. When the rules discourage such profitable activity, the government loses potential revenue. Consequently, resources are diverted to unproductive sectors[73] rather than to the corporation or the government. The combined loss to the government, corporation, and shareholders constitutes the excess burden.

2. Problems with administrative efficiency under the existing rules

The existing rules also fail to meet the administrative efficiency criterion of economic efficiency. The administrative efficiency criterion calls for relatively small tax-compliance transaction costs—the lower the percentage of funds dissipated in collection expenses, the more administratively efficient is the tax.[74] This criterion extends not only to the corporate taxpayer's cost of compliance but also to the government's cost of tax management.[75]

a. Corporate difficulties with administrative efficiency. The high degree of complexity under the existing rules breeds transaction costs. The existing acquisition rules have traditionally been easy targets for criticism because of their complexity.[76] The Reporter remarks that the classification scheme pertaining to section 368 reorganizations is "byzantine in its complication."[77] The existing rules are complex because tax results depend on the choice of form and corporate procedures. Rule drafters define exactly what the form is and what procedures are to be followed. Corporate taxpayers, however, find and use available loopholes to their advantage to effectively elect between nonrecognition and recognition. This in turn forces rule drafters to respond with section 341-type loophole plugs.

If the corporation is to properly interpret the rules, it must employ sophisticted and expensive counsel.[78] This addition to

73. These sectors include, but are not limited to, accountants, lawyers, and bureaucrats.

74. C. Allan, *supra* note 30, at 41.

75. *Id.*

76. Blum, *supra* note 39, at 86. Professor Blum asserts that the existing problems under the rules cannot be resolved using the criterion of equity, rather "we should seek solutions which move in the direction of simplifying the law in operation." *Id.* at 87.

77. 54 A.L.I. Proc. 312 (1977) (May 19, 1977 morning session, remarks of William D. Andrews).

78. Chapman, *supra* note 32, at 13. Although legal fees of tax counsel are deducti-

the cost of actual taxes paid—the portion attributed to administrative inefficiency—may distort market mechanisms. The higher "real" tax represents higher costs. Under traditional theory, marginal producers would drop out in the long run, supply would decrease, and surviving producers would be induced to raise the price of the corporate product.[79]

Nonneutrality in the existing rules may also lead to greater corporate administrative inefficiency. Sophisticated counsel is employed to interpret the rules and to make the best possible effective election. Again, resources are not efficiently allocated. Corporate capital policy is formulated to account for not only productivity but alternative tax consequences as well.[80] According to Professor C. Lowell Harriss of Columbia, "skilled effort is devoted to saving taxes rather than to creating goods and services of positive value or to reducing the input needed for some specific outputs."[81]

The existing complexities also create market timing difficulties for corporate parties to a transaction. These difficulties fail the administrative efficiency criterion and the neutrality criterion. Because the rules are complex and the possible penalties for mistake severe, the corporation is commonly forced to resort to the slow process of obtaining an insurance-like private letter ruling.[82] As a result, a corporation that must delay consumma-

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ble, the deduction merely reduces the total costs to the taxpayer; it does not eliminate them, nor does it reduce incidental preparation expenses. Furthermore, the government incurs a loss equal to the taxpayer's deduction.

79. W. ANDERSON, *supra* note 32, at 303. *See also* Marberry, *supra* note 32, at 323.

80. Harriss, *supra* note 48, at 37.

81. *Id.*

82. Acquisitions and reorganizations under the existing rules typically require a private letter ruling. *See* Kasischke, *How to Request and Obtain a Private Ruling from the IRS and When One Should Do So,* 22 TAX ACCT. 366 (1979); Raby, Berlin & Ellentuck, *How—and When—To Get Ruling,* PRAC. ACCT., May-June 1975, at 16.

The private letter ruling process, however, has not worked well. Although the process is designed "to make the statute work so that the tax law's inordinate complexity will not interfere unduly in the achieving of commercial results that are economically reasonable" and is designed to serve in a "coordinate" capacity, practitioners view the process as adversary, biased against the taxpayer, inflexible, hostile, ritualistic, and inconsistent. *How Practitioners View the Service's Private Letter Ruling Process: A Critique,* 51 J. TAX. 177 (1979).

It often takes sixteen days for a request to reach Technical from the mail room. Excessive delays are encountered when more than one branch of Technical is involved. The new disclosure rules may lead to undue caution. The fifteen-day rule (requiring the tax specialist to call the taxpayer within fifteen days of receiving the request) does not work well. Moreover, the procedure governing expeditious treatment is burdensome. *Id. See also* Moorehead & Sharer, *Reexamination of the Rulings Process—Has the Game*

tion of an intended acquisition is exposed to either additional market risk or, if risk is allocated among the parties by contract, a corporation must reflect risk-contracting in terms of additional cost. Moreover, the corporation must either maintain an "open" transaction or forgo closing an intended transaction—both violations of the tax neutrality criterion.[83]

b. Government difficulties with administrative efficiency. The existing rules also fail the administrative efficiency criterion for economic efficiency because the government must divert excessive resources from general appropriations funds to tax management and collection.[84] Put simply, from the government's perspective an administratively inefficient tax is one which costs more than it should to manage. It may not distort market mechanisms in a specific way as would nonneutrality; instead its effect would be similar to the economic depressant attributed to high taxes in general. A comparatively more efficient tax would result in higher net revenues for the government. Theoretically, tax rates may then be lowered from the nonefficiency level to equal only the needs of government.

The government must divert unnecessary resources from other uses when, under the existing rules, it must continually plug loopholes, answer questions, and pursue violators.

C. *An Attempted Justification of the Existing Rules*

It is doubtful whether the other tax policy objectives or considerations can justify the burdens on economic efficiency under the existing rules. Professor Bittker rather halfheartedly comments that the existing rules "make far more sense than one is led to expect by most popular and some expert opinion on the subject."[85] He sees, buried in turgid prose, excessive detail, and

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Changed? 36 N.Y.U. INST. FED. TAX'N 1207, 1231-32 (1978). The Service may take up to a year or more to issue a ruling covering troublesome issues. Barker, *Planning Business Transactions in View of Uncertainties in Law,* 16 S. CAL. TAX INST. 79, 101 (1964).

83. *See* Barker, *supra* note 82, at 101.

84. C. ALLAN, *supra* note 30, at 43.

85. Bittker, *Reflections on Tax Reform,* 47 U. CIN. L. REV. 185, 194-95 (1978). Professor Bittker quipped:

> Some of you may have seen a recent cartoon in the *New Yorker,* in which a patron of a neighborhood bar says to his drinking companion: "For thirty years I never thought about the Panama Canal, and now I find I can't live without it." In the same vein, many Congressmen and their constituents might have said: "For thirty years I have denounced the complexities of the Internal Revenue Code, and now I find I can't live without them."

Id. at 194.

often indefensible positions, "a surprisingly high level of rationality, judicious compromise, and concern with important social values."[86] Certainly, one cannot claim that the individual rules under the code and regulations are all economically or politically irrational. The great majority of the rules are not arbitrary or egregious.

Rather, the combination of individual rules comprising the existing scheme has two major faults. First, as has been previously discussed, Congress and the Service have chosen to tie the effects of taxation to code-determined corporate procedure.[87] This results in more nonneutrality and administrative inefficiency as more rules are implemented under this policy. Second, the rules have emerged from independent, piecemeal legislation and regulation[88] and not from a concentrated effort to at least acknowledge macroeconomic degradations. The combined effect of the rules unites with the fundamentally adverse corporate income tax[89] to produce a result perhaps far worse than Congress intended.

III. The Proposed Adoption of the ALI Election Mechanism

As noted earlier, the ALI proposals, which would introduce an express election between cost- and carryover-basis acquisitions, represent a major departure from the existing rules. Such an election would allow corporate parties to a transaction the freedom of choosing to recognize or not recognize gain or loss without resorting to the convoluted technicalities in the existing rules.[90] The election proposed by the ALI applies to both stock (usually carryover-basis under existing rules) and assets (usually cost-basis under existing rules) acquisitions. The election mechanism is intended by the Reporter of the project to greatly simplify the acquisition rules and ensure the integrity of the corporate income tax.[91]

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86. *Id.* at 195.

87. *See supra* notes 41-52 and accompanying text.

88. C. Allan, *supra* note 30, at 183.

89. *See supra* notes 36-38 and accompanying text.

90. *See supra* notes 3, 7-10, and accompanying text.

91. *See supra* notes 19-27 and accompanying text.

A. *The Election and Greater Economic Efficiency*

The ALI proposed election mechanism could lead to a much greater degree of economic efficiency than is now present under existing rules. An election between recognition and nonrecognition of gain or loss could lead to a set of tax rules that would be essentially neutral and administratively efficient.

1. *Tax neutrality under the proposals*

A set of rules adopting the election mechanism would be essentially neutral because the desired course—recognition or nonrecognition—could be obtained without altering corporate pocedure. Excess burdens in corporate economic markets arise when an external tax inducement alters corporate behavior.[92] The Reporter claims that the election mechanism will virtually eliminate this tax-corporate procedure conflict by making the "tax classification explicitly elective and as independent as possible of corporate procedural considerations."[93] Therefore, in the first example of the previous discussion of nonneutrality in the existing rules,[94] a corporation that must choose between stock and asset acquisition will find that it is not influenced by major tax differences between the two alternatives. In the second example,[95] a corporation that seeks an indirect asset purchase would not be influenced by a required liquidation. In the third example,[96] a corporation that anticipates a major sale of less than substantially all of its assets would not be influenced by a requirement to hold assets in subsidiary form. In the fourth example,[97] a corporation that seeks to sell a profitable asset would not be influenced by a rule that requires liquidation for nonrecognition.

2. *Administrative efficiency under the proposals*

The proposed election mechanism would, if adopted, lead to greater administrative efficiency because it would simplify the rules[98] and thus reduce the cost of complying with them. The

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92. *See supra* notes 40-51 and accompanying text.
93. T.D. No. 1, *supra* note 1, at 47.
94. *See supra* notes 53-55 and accompanying text.
95. *See supra* notes 57-61 and accompanying text.
96. *See supra* notes 62-67 and accompanying text.
97. *See supra* notes 67-73 and accompanying text.
98. Beghe, *supra* note 1, at 770. *But see* Bock, *Elections vs. Tax Simplification*, 22

complexity of the effective elections under the existing acquisition rules requires high-priced and sophisticated counsel to determine the manner of making the election.[99] Additionally, if complexity were reduced and the alternatives made more clearly obtainable, the necessity of securing a private letter ruling may correspondingly diminish.[100]

An explicit election would also remove existing inducements to complexity. When tax results depend on the choice of form and corporate procedure,[101] the corporate taxpayer is induced to find available loopholes to effectively elect. Meanwhile the government, by virtue of its incentive to maximize revenue, is compelled to close the loopholes and ostensibly dictate what it feels is the necessary tax result from desired corporate activity. This tension leads to complexity as rules are added upon rules.[102] If, however, the election were made explicit, the corporate taxpayer would first determine procedure and secondly make an election to determine the tax results. The corporate taxpayer would no longer find it necessary to maximize its satisfaction under the rules by exploiting loopholes. The government would be faced with fewer loopholes to close: Congress would therefore have fewer code sections to change, the Treasury Department would have fewer regulations to write, and the Commissioner would have fewer rulings to issue.

B. Possible Objections to the Adoption of the ALI Proposals

Some objections to the adoption of the proposals can be expected despite the economic advantages their implementation would foster. Although the analytical literature to date has been favorable and has considered the possible objections to be merely problematic,[103] the competing objectives in tax policy pose potential stumbling blocks. This section will discuss plausible solutions to some of the more obvious objections.

TAXES 304 (1944) (irrevocable elections frequently result in large expenditures of time, effort and money on the part of the taxpayer and do not contribute to simplicity); Hickman, *Federal Tax Regulations—The Need to Expedite and Simplify*, 30 NAT'L TAX J. 313 (1977) (the effective election under § 334(b)(2) adds to complexity).

99. *See* 54 A.L.I. PROC. 316 (1977) (May 19, 1977 morning session, remarks of William D. Andrews); Beghe, *supra* note 1, at 771.

100. *See* Kasischke, *supra* note 82, at 28.

101. T.D. No. 1, *supra* note 1, at 47.

102. *See* Barker, *supra* note 82, at 80.

103. Beghe, *supra* note 1, at 770-71.

1. The tax avoidance motive and the election mechanism

Some may argue that the corporate taxpayer should not be given the socially counterproductive choice of tax avoidance, minimization, or deferral; perhaps an election should be considered improper per se. The object of the Internal Revenue Code, it may be claimed, is to raise revenue. Whereas the existing rules theoretically dictate the desired tax consequences of certain corporate procedures, the ALI election procedure would give the taxpayer the choice of paying a small sum or a large sum. The taxpayer will nearly always choose the smaller—a choice that may be considered by some not to be in the best interests of society.

This objection may be refuted on several grounds. First, the existing rules already allow the taxpayer to make an effective election and thereby reduce the tax liability.[104] Although the present rules may have been intended to reflect a conscious sharing in the profits of corporate activity, the rules in fact may be circumvented by sophisticated counsel. The existing rules serve to discriminate against those who cannot afford to determine available alternatives or those who have ignorantly made procedural moves without consulting counsel.[105]

The Reporter maintains that even if it were possible to eliminate the election, it should not be eliminated.[106] Each mode, the alternative carryover or cost-basis treatments, is important for meeting the varied needs of the taxpayer in particular situations. "Since the taxpayer parties to an acquisition will be best able to determine the relative magnitude of those needs, it makes sense to give them a choice in determining the mode of tax treatment."[107]

Second, the proposals will not result in tax avoidance. On the contrary, they would ensure "that corporate property could not escape from corporate solution without a corporate income tax."[108] "[T]heir enactment would reduce the after-tax proceeds to owner-sellers of corporate business and would therefore increase the overall tax cost of having done business in corporate form."[109] Unlike the existing law, the ALI proposals would not

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104. *See supra* notes 25-27 and accompanying text.
105. Chapman, *supra* note 32, at 13.
106. T.D. No. 1, *supra* note 1, at 44-47.
107. *Id.* at 46.
108. Beghe, *supra* note 1, at 770. *See supra* notes 18-24 and accompanying text.
109. Beghe, *supra* note 1, at 771.

enable appreciated property to leave the corporate solution with a stepped-up basis without income recognition.[110]

Third, many elections[111] or effective elections already abound in the code and regulations. These give the taxpayer the freedom of choice to minimize the effect of taxation. Principal examples of election[112] include the section 453 noninstallment sale reporting election, the section 333 one-month liquidation and shareholder's nonrecognition election, the section 1552 closely held corporations consolidated return election, and the subchapter S election.[113]

The motivations behind the ALI proposals are similar to those behind some of these other elections in the code. Senate Report No. 1983 in 1958 recommended the adoption of the subchapter S provision that permits the shareholders of small-business corporations to elect direct taxation in lieu of payment of the corporate tax.[114] The report confirmed the prevailing belief that "the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."[115] Moreover, section 177 permits a taxpayer to elect amortization of trademark expenditures and was implemented to allow all taxpayers the ability to accomplish what only the sophisticated taxpayer could effec-

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110. *See supra* notes 18-24 and accompanying text.

111. For tax purposes, "election" has been defined as a choice between two or more permissible courses of action to which the taxpayer has an equal right, but both or all of which he cannot have. Stine, *Some Important Factors in Making Elections Under the Internal Revenue Code,* 16 S. CAL. TAX INST. 635, 635 (1964). The act of election must be generally overt and is generally irrevocable. Little, *Saving Taxes by Proper Elections,* 18 TUL. TAX INST. 613, 613 (1968); Note, *The Election Concept in Tax Law,* 47 VA. L. REV. 72, 72-73 (1961).

112. An exhaustive tabulation of elections in the original 1954 Code may be found in Schwanbeck, *Elections and Options Available to Taxpayers in the 1954 Code,* 32 TAXES 748 (1954). *See also* Stine, *supra* note 111; Note, *The Election Concept in Tax Law,* 47 VA. L. REV. 72 (1961).

113. Also included are the § 243 affiliated corporations dividend deduction election, the § 179 additional first-year depreciation allowance election, the § 446 accounting methods election, the § 166 bad debt reserve charge-off election, the § 108 nonrecognition of income from the discharge of indebtedness election, the § 171 amortizable bond premium election, the § 177 amortizable trademark expenditures election, the § 754 partnership basis election, the § 709 amortizable partnership organization expenditures election, and the § 545(c) personal holding company nondeduction of qualified indebtedness election.

114. S. REP. No. 1983, 85th Cong., 2d Sess. § 68, *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4876.

115. *Id.*

tively elect under prior rules.[116]

2. *Revenue sufficiency and the election mechanism*

Some may argue that if the election mechanism were adopted in such an important area of corporate tax law, the taxpayer's choice to minimize taxes would lead to a significant decline in government revenues. As noted earlier, this may not be a valid objection.[117] Under the proposals the integrity of the corporate income tax is preserved, which would result in a larger tax cost to owner-sellers of corporate businesses.[118] On the other hand, if the proposals reduce the incentives to discontinue the corporate form, the proposals could result in a postponement of the day of reckoning—essentially the same as tax reduction. There are three major reasons, however, for not permitting this competing revenue objective to obstruct the adoption of the election mechanism.

First, because the proposals would be much more administratively efficient than the existing rules, the reduction in economic friction would result in larger revenues (and taxable income) for the corporation and a smaller expenditure by the government in tax collection. Although it would be virtually impossible to estimate the incremental benefit to the government by such an improvement, this benefit must certainly receive consideration as a countervailing factor in any possible revenue reduction.

Second, Congress could restructure the corporate tax rates to meet the tax needs of the government. Although the existing rules and proposed rules would therefore yield the same revenues for the government if the tax rates were adjusted accordingly, the resulting increase in economic efficiency could be a boon to both the corporation and the government.

Third, equitable considerations would militate against this revenue sufficiency objection. If it may be assumed that existing rules yield adequate revenue and conceded that an effective election exists for the sophisticated and well informed, then one may conclude that an unfair burden of providing for revenue sufficiency rests with the unsophisticated or ignorant corporate

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116. S. Rep. No. 830, 88th Cong., 2d Sess. § IV(B)(19)(b), *reprinted in* 1964 U.S. Code Cong. & Ad. News 1673, 1747.

117. *See supra* notes 108-10 and accompanying text.

118. *See supra* notes 18-34 and accompanying text.

taxpayer. This disproportionate burden on the smaller corporation violates equity criteria and objectives.

3. *Future complexity under the proposed rules*

Some may pessimistically observe, and perhaps rightly so, that today's simplicity becomes tomorrow's complexity and that the simplification under the ALI proposals would therefore be merely illusory. Proponents of the view would prefer to retain existing but familiar complexity rather than gamble on the unknown complexities of any proposed simplification.[119] According to one commentator, however, this argument is unconvincing: "The objectives and assumptions of the proposals are so clearly and intelligibly set forth as to assure the advancement of simplification, if by only easing the interpretive burdens now placed on courts, administrators, and practitioners."[120]

This answer to the ojection may be carried one step further. Not only are the objectives and assumptions clearly set forth under the proposals; they also minimize existing inducements toward complexity.[121] The tension between the loophole-finding taxpayer and the loophole-plugging government is reduced. Although further refinements are undoubtedly necessary,[122] the basic election concept, if still perceived through the details, should forestall or reduce additional complexity.

4. *Political considerations and electivity*

Finally, one could claim that the implementation of the election mechanism would weaken potential fiscal control. Income taxation is often used by fiscal planners to encourage or prohibit certain conduct and to encourage key industrial development. A system of taxation such as that proposed, which would break the link between corporate procedure and tax consequences and make the taxpayer indifferent to the tax, could virtually eliminate that system as a fiscal tool.

The elimination of taxation as a tool of fiscal control poses questions that are not easily answered. The Reporter, however,

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119. Beghe, *supra* note 1, at 771.

120. *Id.*

121. *See supra* notes 101-02 and accompanying text.

122. The proposals merely represent substance and are not intended to represent sections of the code.

maintains there is "no compelling reason"[123] to tie electivity and procedure together under the existing rules. Notably, when other elections have been implemented in the code and regulations, there has been no real concern over the lack of fiscal control. Moreover, fiscal planners have other tools at their disposal.

IV. Conclusion

Existing corporate acquisition rules under the Internal Revenue Code are not only complex and confusing but also unduly burdensome on economic development. The existing rules are not tax neutral; they often induce the corporation to use procedures that would, but for the tax, be considered unusual or superfluous. This nonneutrality leads to excess burdens in the marketplace and causes the true cost of the tax to exceed the receipts it generates.

The rules are also administratively inefficient. By their complexity they impose high transaction costs on intended acquisitions and subject the acquisition participants to timing difficulties. Valuable resources that would otherwise be used in productive enterprises are shifted to unproductive sectors of the economy. Moreover, the complexity of the rules is administratively difficult and expensive for the government to manage.

A plausible solution lies in the American Law Institute's Corporate Acquisition Proposals, which have emerged from the subchapter C project in the form of Tentative Drafts Nos. 1 and 5. The Tentative Drafts, if adopted, would provide for an explicit election between recognition and nonrecognition of gain or loss in corporate acquisitions. Such a mechanism should lead to tax neutrality and administrative efficiency.

Economic efficiency is not the only objective used to measure tax optimality. It appears, however, that the possible objections to the ALI proposals based on noneconomic objectives do not stand up well to the proposals. The proposals are not likely to contribute to tax avoidance, declines in government revenues, or complexity.

Robert D. Crockett

123. T.D. No. 1, *supra* note 1, at 47.