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Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem

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PREVENTION OF DOUBLE DEDUCTIONS OF A SINGLE LOSS: SOLUTIONS IN SEARCH OF A PROBLEM

Douglas A. Kahn^{} and Jeffrey H. Kahn^{**}*

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I. INTRODUCTION

In the current tax system, a corporation is treated as a separate taxable entity.¹ This tax system is sometimes referred to as an entity tax or a double tax system.² Since a corporation is a separate and distinct entity from its owners, the shareholders, the default rule is that transfers between them are treated as realization events. Without a specific Internal Revenue Code (Code) provision providing otherwise, such transactions will also require the parties to recognize the realized gain or loss.³

Congress has enacted several nonrecognition corporate provisions when forcing the recognition of income could prevent changes to the form of ownership from taking place even if the changes would provide a more efficient and economically beneficial structure. One such provision is section 351, which provides nonrecognition treatment to shareholders who contribute property to a controlled

¹ This article focuses exclusively on domestic C corporations and their shareholders. A “C corporation” is an organization taxed as a corporation that is not an S corporation and an “S corporation” is one for which a valid election under section 1362 is in effect. Citations to “I.R.C.” or to the “Code” are to the Internal Revenue Code of 1986 as amended. In this article, a citation to a section number is to the Internal Revenue Code of 1986 unless indicated otherwise.

² The corporate tax system is labeled a “double tax” system because the corporation is taxed once when it earns income and the shareholders are taxed when the money is distributed to them in their capacity as shareholders. *See generally* DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 25–28 (5th ed. 2001).

³ I.R.C. § 1001(c).

corporation in exchange for corporate stock.⁴ When section 351 applies, the shareholder's basis in the corporate stock received and the corporation's basis in the contributed property are calculated to carry forward any realized, but unrecognized gains or losses (subject to certain exceptions described in this article).⁵

Assume, for example, that *A*, an individual taxpayer, transfers Blackacre, unimproved land, to *X* Corporation (*X*) in exchange for 100 shares of *X* Corporation stock. *A*'s basis in Blackacre is \$50,000 and the fair market value of the property is \$100,000. Assume *A* is the sole shareholder of *X* and therefore the exchange qualifies for nonrecognition treatment under section 351. *A*'s basis in the *X* Corporation stock received in the exchange is the same basis that *A* had in Blackacre, \$50,000.⁶ *X* takes a transferred basis in Blackacre. *X*'s basis in the contributed property is the same as *A*'s basis at the time of the contribution, so *X* has a \$50,000 basis in Blackacre.⁷

Until fairly recently, this same treatment applied when a shareholder contributed depreciated property.⁸ Going back to the example above, assume the property's fair market value is \$20,000 and *A*'s basis is still \$50,000. For the moment, ignore any specific limitations that apply to this transaction. Ignoring those limitations, *A*'s basis in the *X* Corporation stock received in the exchange would again be the same \$50,000 basis that *A* had in Blackacre; and *X* would also take a \$50,000 basis in Blackacre.⁹

It is not difficult to understand why some commentators and Congress view this example as abusive. *A* has used the corporate tax system to create two depreciated assets from one. That is, *A* took the depreciated asset Blackacre and, through a nonrecognition exchange with *X*, created the depreciated asset of *X* Corporation stock while also the corporation kept Blackacre as a depreciated asset. *A* was able to create two tax losses (the loss that *X* will recognize when *X* sells Blackacre and the loss that *A* will recognize when he sells his *X* Corporation stock) from one depreciated asset.

In Part V of the article, we explore the question of the extent to which the creation of a double loss should be considered an abuse of

⁴ I.R.C. § 351(a). See generally KAHN & LEHMAN, *supra* note 2, at 616–19.

⁵ I.R.C. §§ 358, 362.

⁶ I.R.C. § 358(a).

⁷ I.R.C. § 362(a).

⁸ An “appreciated” asset is one whose fair market value is greater than its adjusted basis. A “depreciated” asset is one whose adjusted basis is greater than its fair market value.

⁹ I.R.C. §§ 358(a), 362(a).

the tax system. As our title suggests, we conclude that it is an abuse only in limited circumstances and that Congress has overreacted in prohibiting all duplications of net built-in losses. It would be better to tailor the restrictions to deal with those situations that are abusive. Believing that any duplication of a net loss is an abuse, however, Congress passed several provisions that prevent taxpayers from creating a double net loss. As discussed in detail below, Parts II through IV of the article review the operation of those provisions and illustrate significant problems with their approaches. While those provisions provide useful background material and illustrate the history of congressional attempts to restrict the areas in which double losses can be utilized, a reader interested only in our discussion of why the creation of a double loss often is not an abuse may skip directly to that section of the article.

Prior to 1986, the so-called *General Utilities* doctrine prevented a corporation from recognizing a gain or loss on the distribution of appreciated or depreciated assets to its shareholders.¹⁰ While most of the *General Utilities* doctrine was repudiated by amendments made as part of the Tax Reform Act of 1986, a number of inroads to the doctrine had arisen before that date.¹¹ As a consequence of the 1986 amendments, subject to an exception for the liquidation of a controlled subsidiary,¹² a corporation is required to recognize gain on making a distribution of appreciated property to its shareholders, regardless of whether it was a liquidating or nonliquidating distribution.¹³ As to losses realized on a corporation's distribution of a depreciated asset, different treatment is accorded to liquidating distributions than to nonliquidating distributions. A corporation will not recognize a loss on making a nonliquidating distribution of

¹⁰ The doctrine derives its name from the 1935 decision of the Supreme Court in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 206 (1935). As applied to liquidating distributions, the doctrine preceded that case and can be traced to a regulation promulgated in 1919 that denied a corporation the realization of gain or loss on liquidating distributions. Treas. Reg. § 45, art. 547 (1919), reprinted in 134 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950, 140 (Bernard D Reams, Jr. ed. 1979).

¹¹ See KAHN & LEHMAN, *supra* note 2, at 117-18.

¹² I.R.C. §§ 332, 337.

¹³ I.R.C. §§ 311(b), 336(a). As used herein, a "liquidating distribution" refers to a distribution pursuant to the complete liquidation of the corporation. A "nonliquidating distribution" refers to all other corporate distributions to shareholders on account of, or in redemption of, their stock. Consequently, a distribution made pursuant to a partial liquidation of a corporation will be included in the term "nonliquidating distribution."

depreciated property.¹⁴ However, subject to limitations, section 336(a) provides that a corporation will recognize a loss on making a liquidating distribution of depreciated property.¹⁵ A corporation realizes a loss on making a liquidating distribution of an item of property in the amount by which its basis in the property exceeds the property's fair market value. The limitations on the corporation's recognition of its realized loss are set forth in section 336(d)(1)-(2).¹⁶ It is a thesis of this article that two of the three limitations imposed by section 336(d)(1)-(2) no longer serve a useful purpose, contravene policies underlying a Code provision adopted more recently, sometimes produces harsh, inappropriate consequences, and so should be repealed. The one remaining limitation of section 336(d)(1) never did serve a useful purpose, so it never should have been adopted.

Part II of this article examines the operation of section 336(d)(1)-(2) and explores the likely reasons for the adoption of each of the limitations that it imposes. Part III examines section 362(e) that was adopted in 2004 to deal with a corporation's acquisition of a depreciated asset from a shareholder in such manner as to provide both the corporation and the shareholder with a built-in loss. Part IV considers the merits and defects of the limitations provided by section 336(d)(1)-(2), the effect that the adoption of section 362(e) has on those provisions, and whether the section 336 provisions should be repealed. Part V questions whether the doubling of a loss deduction when a shareholder contributes a depreciated asset to a corporation (one potential deduction for the shareholder and one for the corporation) is an abuse of such scope that it warrants the blanket prohibition that Congress adopted. Part VI sets forth the authors' conclusions.

¹⁴ I.R.C. § 311(a).

¹⁵ One exception to this rule applies to the liquidation of a controlled subsidiary. See I.R.C. § 336(d)(3); see also I.R.C. §§ 332, 336(a), 337. Section 267(a)(1), which denies a deduction for losses recognized on a sale or exchange between related parties, does not apply to corporate liquidating distributions.

¹⁶ Section 336(d)(3) prevents a controlled subsidiary from recognizing a loss on making liquidating distributions and the authors have no complaint about that provision. But see George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 575, 623-24 (1987) (contending that loss recognition should not be denied for distributions to minority shareholders). The provisions that the authors believe should be repealed are section 336(d)(1)-(2).

II. THE LIMITATIONS IMPOSED BY SECTION 336(D)(1)–(2)

When Congress repealed the *General Utilities* doctrine in the Tax Reform Act of 1986, it expressed a concern that taxpayers could utilize various means to turn that repeal to their advantage.¹⁷ To prevent that from occurring, in the same Act, Congress added subsections (d)(1)–(2) to section 336. Neither the House bill nor the Senate's amendments to the bill that became the 1986 Act had a provision comparable to subsections (d)(1)–(2); the provisions were added in the conference agreement.¹⁸ Perhaps it is due to their last minute addition to the 1986 Act that these provisions are so poorly crafted.

A. The Operation of Subsection (d)(1)

Subsection (d)(1) applies only to liquidating distributions that are made to a shareholder who is a related person within the meaning of section 267. Note that the express terms of section 267(a)(1), which prevent a deduction for losses recognized from sales and exchanges between related persons, make that provision inapplicable to corporate liquidations. Congress determined in 1986 to impose a limitation on the deduction of losses from corporate liquidations, but in only a few limited circumstances. If the shareholder is an individual, the shareholder is a related person if, after applying certain stock attribution rules,¹⁹ the shareholder owns more than 50% in value of the liquidating corporation's outstanding stock.²⁰ If the shareholder is itself a corporation, the shareholder will be a related person if it owns stock of the liquidating corporation having either more than 50% of the value of the liquidating corporation's outstanding stock or more than 50% of the total voting power of the liquidating corporation's outstanding voting stock.²¹ If, however, the liquidating corporation is a controlled subsidiary, so that section 332 applies to the liquidation, then the liquidating corporation cannot recognize a loss on a distribution to any shareholder regardless of whether the

¹⁷ H.R. REP. NO. 99-841, pt. 3, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N 4075, 4286.

¹⁸ *Id.* at II-198 to II-200.

¹⁹ For this purpose, a shareholder is deemed to own stock that is owned by some other person who bears a specified relationship to the shareholder. I.R.C. § 267(c).

²⁰ I.R.C. §§ 267(b)(2), 336(d)(1)(A).

²¹ I.R.C. §§ 267(b)(3), 267(f)(1), 336(d)(1)(A).

shareholder is a related person.²²

A liquidating corporation is not barred by subsection (d)(1) from recognizing a loss on all distributions to related persons. There are only two situations in which that provision prevents a corporation from recognizing a loss.²³ The first is when the distribution of the depreciated property was not made pro rata to the shareholders.²⁴ The second is when the depreciated property constitutes “disqualified property.”²⁵ “Disqualified property” is property that was acquired by the liquidating corporation within five years of the distribution either in a section 351 exchange,²⁶ or as a contribution to the corporation’s

²² I.R.C. § 336(d)(3); *see also* I.R.C. §§ 332, 337(a).

²³ Of course, if the liquidating corporation is a controlled subsidiary and if section 332 applies to the liquidation, then the liquidating corporation will not recognize a loss on any of its liquidating distributions. *See* I.R.C. § 336(d)(3); *see also* I.R.C. §§ 332, 337(a).

²⁴ I.R.C. § 336(d)(1)(A)(i). The most plausible construction of that provision is that it applies when a distribution of depreciated property to a related person is other than that person’s pro rata portion of the depreciated property. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 10.05[3][a] at 10-33 (7th ed. 2002). If that construction is adopted, a distribution of depreciated property to a related person of the latter’s pro rata share of that property will not trigger this limitation provision even if non-pro rata distributions were made to other shareholders. However, contrary to that construction, the so-called Blue Book to the Tax Reform Act of 1986 (a general explanation of the Act prepared by the staff of the Joint Committee on Taxation) states: “a liquidating corporation may not recognize loss with respect to a distribution of property to a related person . . . unless . . . the property is distributed to all shareholders on a pro rata basis. . . .” STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986*, 341 (Joint Comm. Print 1987), *available at* <http://www.house.gov/jct/jcs-10-87.pdf> [hereinafter BLUE BOOK].

Note that section 336(d)(1) does not apply to liquidating distributions to a shareholder who is not a related person and so the corporation’s realized loss on making such a distribution will be recognized unless some other Code provision disallows it.

²⁵ I.R.C. § 336(d)(1)(A)(ii).

²⁶ A transfer of property to a corporation in exchange for stock of the latter is referred to in this article as a “section 351 exchange” if the exchange qualifies for treatment under section 351 of the Code. Section 351 provides nonrecognition for an exchange of property for a corporation’s stock if certain conditions are satisfied. If section 351 applies to an exchange, the corporation generally takes the same basis in the property it acquired that the shareholder had in it and the shareholder takes the same basis in the stock received as the basis that the shareholder had in the property that was transferred to the corporation. I.R.C. §§ 358(a), 362(a); *see* I.R.C. § 351. An alteration of those general rules for the determination of basis for depreciated property was adopted in 2004 and is discussed in Part III of this article. *See* I.R.C. §

capital.²⁷ Note that there is no requirement that the property acquired within the five-year period was a depreciated asset when acquired; it is necessary only that it was acquired in either a section 351 exchange or as a contribution to capital.

B. The Operation of Subsection (d)(2) — The Anti-Stuffing Provision

Subsection (d)(2) also applies to property that was acquired by a liquidating corporation in a section 351 exchange or a contribution to capital, but subsection (d)(2) applies only if the acquired property was depreciated at the time of its acquisition.²⁸ Subsection (d)(2) is sometimes referred to as the “anti-stuffing provision.” Unlike subsection (d)(1), whose application rests exclusively on objective factors, subsection (d)(2) applies only if a principal purpose of the liquidating corporation’s acquisition of the depreciated asset was to recognize a loss on that property in connection with a liquidation.²⁹ While the provision does not explicitly set a time frame for its operation, it does state that if the asset was acquired within two years of the date on which the corporation adopted a plan of liquidation, the asset will be treated as having been acquired for the tainted purpose, except as provided otherwise in regulations.³⁰ Despite the strict language of that provision, the legislative history indicates that the two-year provision merely creates a rebuttable presumption and that this presumption will be disregarded if there is a clear and substantial relationship between the contributed property and the conduct of the corporation’s current or future business enterprises.³¹ The presence of

362(e). For our purposes, we will ignore other adjustments to basis that apply in certain circumstances because they do not impact the issues discussed herein. For example, the basis of both the stock received and the property transferred may be altered if the transferee assumes a liability in the transaction or if the transferor receives boot (i.e. property other than qualified stock of the transferee corporation). See I.R.C. §§ 358(a), (d)(1), (h), 362(a), (d).

²⁷ I.R.C. § 336(d)(1)(B). The term also includes any property in the hands of the liquidating corporation whose adjusted basis is determined, in whole or in part, by reference to the adjusted basis of disqualified property. *Id.* For example, if an item of disqualified property were exchanged for property of like kind in an exchange that qualified for nonrecognition under section 1031, the replacement property will also be disqualified property since its basis is determined under section 1031(d) by reference to the basis of the exchanged property.

²⁸ I.R.C. § 336(d)(2)(A).

²⁹ I.R.C. § 336(d)(2)(B)(i)(II).

³⁰ I.R.C. § 336(d)(2)(B)(ii).

³¹ H.R. REP. No. 99-841, pt. 3, at II-201 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.A.N. 4075, 4286. The conferees also stated that the provision generally will

a “presumption” for acquisitions within the two-year period would not, by itself, show that acquisitions made prior to the two-year period are necessarily excluded from the subsection (d)(2) limitation; but the legislative history indicates that the rule will be applied to acquisitions made more than two years prior to the adoption of a plan of liquidation “only in the most rare and unusual . . . circumstances.”³²

If subsection (d)(2) applies, it does not explicitly deny recognition of a loss. Instead, it causes a reduction of the corporation’s basis in the acquired asset, but only for the purpose of determining a loss. The reduction of basis will effectively deny the corporation that amount of loss deduction, but the significance of accomplishing that through a reduction of basis is that it will limit the corporation’s loss on a sale of the acquired asset as well as on liquidating distributions. The amount of reduction of the corporation’s basis in the asset is equal to the amount by which the asset was depreciated at the time of acquisition (i.e., the built-in loss).³³ The following example illustrates how subsection (d)(2) operates:

Example 1. On September 12, 2000, *F* transferred Blackacre (unimproved land) to the *X* Corporation in exchange for 10 shares of *X* stock and the exchange qualified for nonrecognition under section 351. The 10 shares of stock had a fair market value of \$75,000. *F* had a basis of \$120,000 in Blackacre, which had a fair market value of \$75,000 at the time of the exchange. While *F* realized a \$45,000 loss on that exchange, none of the loss was recognized because of section 351. In the absence of section 336(d)(2), *X* would have a basis of \$120,000 in Blackacre³⁴ and *F* would have a basis of \$120,000 in the 10 shares of stock he received in the exchange. On February 4, 2001, *X* sold Blackacre to an unrelated party for its then fair market value of \$70,000. If nothing else had taken place, *X* would recognize a loss of \$50,000 on that sale (\$120,000 basis minus the \$70,000 selling price). On June 3,

not apply to property acquired by the corporation within the first two years of its existence. *Id.* See also BLUE BOOK, *supra* note 24, at 344.

³² H.R. REP. 99-841, pt. 3, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286. See also BLUE BOOK, *supra* note 24, at 343.

³³ I.R.C. § 336(d)(2)(A). The statute accomplishes this by reducing the corporation’s basis by the amount by which the adjusted basis of the asset exceeded its fair market value immediately after the acquisition.

³⁴ I.R.C. § 362(e)(2), which was adopted in 2004, does not apply to this example because the transactions occurred prior to the effective date of that provision.

2002 (less than two years after *X* acquired Blackacre in a section 351 exchange), *X* adopted a plan of liquidation and liquidated a few months later. *F* received \$70,000 cash from *X* as a liquidating distribution on the 10 shares of *X* stock that *F* had acquired in the exchange and *F* thereby recognized a \$50,000 loss (\$120,000 basis minus the \$70,000 selling price). Of the \$50,000 loss amount, \$45,000 is attributable to the decline in Blackacre's value at the time of the section 351 exchange. So, if subsection (d)(2) is not applicable, the \$45,000 built-in loss of Blackacre's value at the time of the section 351 exchange will be recognized twice — once by *X* and once by *F*.

Assume that it is determined that a principal purpose of *X*'s acquisition of Blackacre was to recognize a loss on a sale of the property in anticipation of a liquidation and that section 336(d)(2) applies to the transaction. Accordingly, for the purpose of determining the loss that *X* recognized on the 2001 sale, the basis of Blackacre in *X*'s hands is reduced by the \$45,000 amount by which the property was depreciated at the time of the exchange. So, for loss purposes, *X* had a basis of \$75,000 in Blackacre and recognized a loss of \$5,000 (\$75,000 basis minus the \$70,000 selling price) on the 2001 sale.

When *X* sold Blackacre in 2001, *X* did not know that subsection (d)(2) would apply since a plan of liquidation had not yet been adopted. Assume that *X* reported on its tax return for 2001 a \$50,000 loss from the sale. How should *X* correct that report? *X* can file an amended return for 2001 and change the loss from the sale to \$5,000. As an alternative, Congress authorized the Treasury to promulgate regulations that would allow *X* to include \$45,000 in income in its return for 2002 in lieu of reducing its 2001 loss by \$45,000.³⁵ However, no regulation has yet been promulgated to allow that alternative.

If, instead of selling Blackacre on February 4, 2001, *X* had liquidated and distributed Blackacre pro rata among its shareholders, none of whom is a related person, subsection

³⁵ I.R.C. § 336(d)(2)(C).

(d)(2) would reduce *X*'s basis in Blackacre to \$75,000 for the purpose of measuring the loss on the distributions. The resulting reduction of the loss recognized applies to the distributions to all the shareholders even though they are not related parties. Each shareholder will take a basis in his distributed portion of Blackacre equal to the fair market value of that portion.³⁶

If both subsections (d)(1)–(2) apply to the same liquidating distribution, subsection (d)(1) takes precedence.³⁷ The order of priority is important because subsection (d)(1) disallows the entire amount of loss realized on a liquidating distribution to a related person whereas subsection (d)(2) effectively disallows only the amount that does not exceed the built-in loss at the time of the corporation's acquisition of the property.

C. Congressional Reasons for Adopting Subsections (d)(1)–(2)

The Conference Report on the Tax Reform Act of 1986, commenting on the inclusion in the Act of the limitations on recognition of losses imposed by section 336(d), stated:

The conferees are concerned that taxpayers may utilize various means to avoid the repeal of the *General Utilities* doctrine, or otherwise take advantage of the new provisions, to recognize losses in inappropriate situations or inflate the amount of losses actually sustained. For example, under the general rule permitting recognition of losses on liquidating distributions, taxpayers may be able to create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contribution of built-in loss property. Consequently, the conference agreement includes two provisions intended to prevent the recognition of such corporate level losses.³⁸

The two provisions to which the Conference Report referred were described immediately after the quoted paragraph and are enacted as

³⁶ I.R.C. § 334(a).

³⁷ See BLUE BOOK, *supra* note 24, at 342 n.86.

³⁸ H.R. REP. NO. 99-841, pt. 2, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286.

section 336(d)(1)–(2).³⁹

Let us consider what abuses the conferees likely had in mind. First, consider how, in the absence of any limitations, a shareholder might have been able to duplicate “shareholder losses in corporate solution.”⁴⁰ Take Example 1 above⁴¹ in which *F* owned Blackacre (unimproved land) with a basis of \$120,000, and a fair market value of \$75,000. If *F* had sold Blackacre for its value (instead of making the section 351 exchange), *F* would have recognized a loss of \$45,000.⁴² Instead, *F* exchanged Blackacre for 10 shares of *X* stock. *F* obtained a basis of \$120,000 in the 10 shares of stock, which had a value of \$75,000 when *F* acquired them. So, *F* can sell those 10 shares (or surrender them in a liquidation of *X*) and recognize a loss of \$45,000 (\$120,000 basis minus the \$75,000 selling price).⁴³ In addition, *X* Corporation obtained a basis of \$120,000 in Blackacre. If *X* were to sell Blackacre for its \$75,000 value, *X* would also recognize a loss of \$45,000 (\$120,000 basis minus the \$75,000 selling price).⁴⁴ Thus, the single \$45,000 loss in the hands of *F* would be duplicated by permitting *F* to retain that loss and yet allowing *X* to recognize the same amount of loss. A doubling of the loss would also occur if *X* were to liquidate and distribute Blackacre to its shareholder as a liquidating distribution. While a doubling of the loss facially appears to be an abuse and Congress clearly considered it to be one, we will question in Part V of this article the extent to which it is an actual abuse.

In its adoption of the 1986 limitations, Congress focused on the extent to which the repeal of the *General Utilities* doctrine opened up opportunities for abuse in the context of liquidations. So, the limitations that Congress adopted in subsections (d)(1)–(2) apply only if the corporation is liquidated even though the same problem can arise in nonliquidating circumstances. Congress again addressed the doubling of losses in 2004 when it added subsection (e) to section 362

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ See *supra* Part II.B.

⁴² If Blackacre was held by *F* as an investment, the loss would be deductible under section 165(c)(2) as a capital loss, subject to the limitations in section 1211(b).

⁴³ The loss would be a deductible capital loss under section 165(c)(2), subject to the limitations in section 1211(b).

⁴⁴ The loss likely would be deductible either as a capital loss under section 165(a), subject to the limitation in section 1211(a), or as a loss under section 1231. You will recall that the transaction described in Example 1 took place prior to the effective date of section 362(e)(2), so that provision is inapplicable.

of the Code⁴⁵ and the application of that provision is not limited to liquidations.⁴⁶ Section 362(e) is discussed in Part III.

1. Subsection (d)(2)

The anti-stuffing provision of subsection (d)(2) obviously is aimed at the doubling of loss problem and the prevention of that doubling appears to be the sole purpose of that provision. Subsection (d)(2) accomplishes that goal by reducing the corporation's basis in the acquired depreciated asset to eliminate any built-in loss. The corporation's basis in the acquired asset is limited to the fair market value of the asset at the time of the corporation's acquisition, but only for the purpose of determining a loss. While the basis reduction provision prevents the realization of a built-in loss whether the asset is distributed to shareholders or sold to an outsider, it applies only if the corporation adopts a plan of liquidation; and, even then, applies in very limited circumstances. It rarely will apply if the plan of liquidation is adopted more than two years after the acquisition of the asset and the legislative history indicates it frequently will not apply even when the plan is adopted within the two-year period.⁴⁷ We will examine in Part IV of this article the effect that the 2004 adoption of section 362(e) has had on the operation of subsection (d)(2).⁴⁸

⁴⁵ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 836, 118 Stat. 1418, 1594-96 (2004).

⁴⁶ Congressional concern over the creation of loss deductions is reflected in its adoption of several other amendments to the Code. In the year 1999, Congress added section 362(d)(1) to the Code to prevent a corporation's basis in property acquired in a section 351 exchange or a reorganization from exceeding the property's fair market value to the extent that the excess basis that otherwise would have existed was generated by gain that the transferor recognized because of the transferee corporation's assumption of liabilities. Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b), 113 Stat. 127, 182 (1999). In the year 2000, Congress added section 358(h) to the Code to prevent a corporate transferee's assumption of a liability in connection with certain nonrecognition transactions from providing the transferor with a basis in the stock received that is greater than the stock's fair market value. Pub. L. No. 106-554, tit. III, § 309(a), 114 Stat. 2763, 2763A-638 (2000). In addition, in 2004, Congress amended several partnership tax provisions to prevent the doubling or shifting of losses. See Pub. L. No. 108-357, § 833, 118 Stat. 1418, 1589-92 (2004) (amending I.R.C. §§ 704(c)(1)(C), 734, and 743).

⁴⁷ See H.R. REP. No. 99-841, pt. 3, at II-200-01 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286; BLUE BOOK, *supra* note 24, at 343; *supra* text accompanying notes 31-32.

⁴⁸ The effect that the adoption of section 362(e)(2) has had on section

2. The Disqualified Property Provision of Subsection (d)(1)

The doubling of loss possibility likely was the principal concern of the disqualified property provision in subsection (d)(1).⁴⁹ Insofar as that provision is aimed at double loss recognition, it suffers from both over-inclusiveness and under-inclusiveness. It applies even when the property was not depreciated at the time it was acquired by the corporation, in which case no doubling of a built-in loss is involved. It applies only to liquidating distributions to a related person, so it does not prevent a doubling of loss by having the corporation sell an acquired depreciated asset or distribute it to a minority shareholder. There is discussed below a possible explanation for those glitches in the provision,⁵⁰ but the authors do not find it convincing.

When a corporation distributes property in liquidation to a related person, the parties have a tax incentive to undervalue the distributed property in order to create or increase the size of a deductible loss or to decrease the size of a gain, for both the liquidating corporation and the shareholder. The risk of undervaluation at the time of liquidation is just as present for property that the corporation had purchased as it is for property that the corporation had acquired in a section 351 exchange or a contribution to capital within five years of the distribution. Why, then, did Congress apply the disqualified property limitation only to property acquired in the latter manner? Perhaps Congress concluded that the risk may be slightly greater if the property was acquired recently in a section 351 exchange or through a contribution.⁵¹

When the distributed property had previously been purchased by

336(d)(1)–(2) is described in Boyd C. Randall et al., *The Interaction of New Section 362(e)(2) with the Loss Disallowance Rules in Corporate Liquidations*, 32 CORP. TAX’N 24 (2005). See also STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 343–44 (6th ed. 2005).

⁴⁹ See *supra* notes 38–46 and accompanying text. See also Yin, *supra* note 16, at 624–25, 629.

⁵⁰ See *infra* Parts IV.B, IV.C.

⁵¹ Support for the possibility that valuation concerns were part of the congressional purpose for adopting section 336(d) is found in the Conference Committee’s Report on the part of the 1986 Act that addressed that subsection. See H.R. REP. NO. 99-841, pt. 2, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.A.N. 4075, 4286; *supra* text accompanying note 38. The conferees expressed their concern that a corporation could be utilized to create artificial losses or to inflate the amount of losses. For reasons stated in the text above, the authors do not believe that the disqualified property provision was adopted to deal with that concern. Instead, the authors believe that the pro rata provision was aimed at that problem.

the corporation from an unrelated person, the purchase price will be deemed to equal the value of the property at that time, so the corporation typically will need to show that the property had subsequently declined in value in order to claim a loss deduction on liquidation. When a corporation acquires property in a section 351 exchange, there is no purchase price to establish the value of the property. The parties typically will set a value for the property to determine how many shares of stock the transferor is to receive. It is possible that the parties would set a low value on the contributed property in order to lend credibility to a low valuation when an anticipated liquidation of the corporation takes place. However plausible that scenario may be, and the authors deem the likelihood to be remote, the value the parties assigned to the property on its acquisition by the corporation will have little weight, if any, in the determination of the value at liquidation. Note that if the distributed disqualified property was not undervalued at the time of its acquisition (including if no valuation was made then), the risk of its being undervalued at liquidation is no different for that property than for purchased property.

If concern over valuation had been one of the reasons for the adoption of the disqualified property provision, it would be understandable that Congress did not apply that provision when the depreciated property is sold to an unrelated person, because there is no valuation issue in that case. However, as discussed below, the authors conclude that the disqualified property provision was not aimed at valuation issues.

Since the provision applies only when the distributed property ends up in the hands of a related person, it might seem that the parties would not care that an inaccurate valuation is used; but that is not necessarily true. The undervaluation at liquidation will cause a disproportionality in the allocation of the corporation's assets unless the liquidating distribution is made pro rata among the shareholders. If the shareholders are related, they may be willing to accept some disproportionality in order to provide a tax benefit for the corporation and the distributee. But, if there are shareholders who are not closely related, an undervaluation of the property transferred to the corporation will result in the transferor having a smaller interest in the corporation than is warranted; and the undervaluation of a non-pro rata liquidating distribution will overcompensate the shareholders to whom that distribution is made. The transferor is likely to complain about receiving a smaller interest in the corporation than the contribution warrants and the other shareholders are likely to

complain if a distributee of the depreciated property receives a larger share of the corporation's assets than is warranted. That may not be a problem if the contributing shareholder is the same person (or a relation) as the person who receives the liquidating distribution because the shortfall in the value received by the transferor may be compensated by the excess distribution received on liquidation. But, if the contribution is made by one shareholder and the liquidating distribution is made to an unrelated shareholder, the resulting disproportionality will be a strong incentive not to engage in that scheme. Of course, if the distributions of the depreciated property are made pro rata, none of the shareholders will suffer because of an undervaluation of the property, so there would be no market constraint against an undervaluation.

The disqualified property provision does not require, as a condition of its application, that the person who transferred the property to the corporation be the identical person (or a relative) who receives the property in liquidation. In the absence of that identity or a pro rata distribution, the usual arms' length consideration should validate the valuations that are used — that is, valuations that are agreed upon by persons acting at arms' length are generally accepted by the Internal Revenue Service (Service) and the courts. While a corporation and a related person may not be at arms' length to each other, they cannot short change the minority shareholders unless the latter acquiesce. The minority shareholders have an enforceable right to be treated fairly and they are at arms' length to any action that is adverse to their economic interests. The liquidating distribution to a majority shareholder could not be undervalued without the acquiescence of the minority shareholders. While the minority shareholders might sleep on their rights out of ignorance or inertia, their presence as an adverse party with veto power should be sufficient to give credibility to the valuation.

In any event, the risk of a deliberate undervaluation taking place at the time of the corporation's acquisition of the property likely is small and will have little or no effect on the valuation at liquidation. A disallowance of recognition for the entire loss that was realized on the corporation's liquidating distribution to a related person is far too severe and expansive a remedy for a risk of such little probability and significance. For that reason, the authors conclude that the congressional purpose for adopting the disqualified property provision had no relation to valuation issues.

Even if, contrary to the authors' conclusion, restraint of undervaluation were deemed to be one object of the disqualified

property provision, there is no reason to impose that limitation if the parties did not utilize a value that was less than the basis when the corporation acquired the property in a section 351 exchange or contribution. In that circumstance, a subsequent claim of a loss on liquidation will have no more credibility than does a loss claimed on the distribution of purchased property. There is no reason to impose a limitation just because the distributed property was acquired in a nonrecognition transaction.

Even in the unlikely event that Congress was concerned about the possibility of undervaluation, there is no reason to be skeptical of valuations that were subject to minority shareholder oversight. When there is reason to be skeptical, the Service is not barred from challenging the valuation. There are numerous examples in the tax law of circumstances where valuation can become an issue (e.g., estate and gift taxes, charitable contributions, and casualty and theft losses). The Service and the courts deal with those issues daily. There is no reason to conclude that the problem of valuation is peculiarly difficult in the case of corporate liquidations. Accordingly, the authors do not believe that valuation issues justify the disqualified property provision; nor do the authors believe that Congress considered valuation to be of concern in this context. The purpose and justification of the provision must be found elsewhere and the single purpose that comes forward is an attack on a double allowance of recognition of a built-in loss. As noted earlier in this article, the Conference Report on the portion of the 1986 Act that adopted section 336(d) stressed the duplication of built-in losses as an object of concern.⁵²

Note that a duplication of loss recognition is permitted and is not deemed objectionable when the decline in value of an asset occurred in the hands of the corporation. In that case, the decline in the corporate asset's value will be mirrored in a similar decline in the value of the shareholder's stock, but the duplication of losses at both entity levels is not deemed objectionable. Only when the double deduction is created by a transfer of a built-in loss to the corporation does the duplication become objectionable; and, even then, in Part V the authors question the extent to which that duplication is

⁵² See *supra* note 37 and accompanying text. It should be noted, however, that the Conference Report also mentions the concern that taxpayers might utilize corporations to create artificial losses or to inflate the amount of losses. For the reasons described above in the text, it is the view of the authors that the conferees concern over valuation issues was addressed to the pro rata provision rather than to the disqualified property provision.

objectionable.

3. The Pro Rata Requirement of Subsection (d)(1)

The other limitation of subsection (d)(1) is the denial of a deduction for a non-pro rata distribution to a related person.⁵³ That provision is not designed to prevent the doubling of losses. The question is: what possible purpose does that provision have? One possible purpose was to prevent the recognition of loss when the depreciated asset remains in the hands of a related person (an adaptation of the purpose of section 267);⁵⁴ but, if that were the purpose, there would be no reason to permit the recognition of loss when the asset is distributed pro rata. Instead, the limitation appears to be aimed at the risk that the parties will undervalue the depreciated asset in order to increase the corporation's loss.⁵⁵ The provision seems to be based on the notion that undervaluation is more likely to occur if a related person receives a disproportionate share of the asset, whether disproportionately larger or smaller. Since the provision does not prevent a corporation from recognizing a loss on the sale of a depreciated asset, even if sold pursuant to a plan of liquidation with a distribution of sale proceeds to a related person, it appears that Congress's focus was on the risk of undervaluation. We will examine the merits of the pro rata provision in Part IV.C of this article. One difficulty with ascribing a purpose to the pro rata provision is that it operates so poorly to implement any possible purpose that its structure seems to contradict the existence of any purpose one might suggest.

⁵³ I.R.C. § 336(d)(1)(A)(i). *See supra* note 24.

⁵⁴ In Bittker and Eustice's treatise, the authors refer to the pro rata provision as effectively reinstating section 267(a)(1)'s application to corporate liquidations. BITTKER & EUSTICE, *supra* note 24, at 10–33. George Yin came to the same conclusion although he conceded that the operation of the pro rata rule is not harmonious with the operation of section 267. Yin, *supra* note 16, at 620–23, 628. If that is the reason for Congress's adoption of the pro rata provision, and the authors of this article conclude otherwise, Congress adopted a much narrower provision and one that is inconsistent with the policy underlying section 267(a)(1). In Part IV.C, the authors discuss the relationship of the pro rata provision to section 267(a)(1). The authors' view is that the pro rata provision is not merely inharmonious with section 267; its operation is so at odds with the purpose and function of section 267 that it bears no relationship to that section and was adopted for an entirely different purpose.

⁵⁵ *See* H.R. REP. NO. 99-841, pt. 2, at II-200 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.C.A.N. 4075, 4286; *supra* text accompanying notes 38, 51.

III. THE OPERATION OF THE SECTION 362(E) LIMITATIONS ON A CORPORATION'S USE OF BUILT-IN LOSSES

Section 836(a) of the American Jobs Creation Act of 2004 added subsection (e) to section 362.⁵⁶ The purposes of that amendment were to prevent: (1) the duplication of a single economic loss in which the same decline in value of an asset could be deducted twice, and (2) the transfer to a U.S. corporation by a foreign person of a built-in loss in a depreciated asset.⁵⁷

A. Subsection (e)(1)

Section 362(e) deals with two separate circumstances in which built-in losses are transferred to a domestic corporation. The first of these is addressed in subsection (e)(1). Section 362(e)(1) deals with the transfer of depreciated property to a domestic corporation by a person who is not subject to United States taxation (i.e., generally a foreign person) as part of either a contribution to the corporation, a section 351 exchange, or a corporate reorganization. If the aggregate basis of the transferred property exceeds the aggregate fair market value of those properties, the corporation's basis in each of the properties that were transferred by that person (both appreciated and depreciated properties) will equal the fair market value of that property. Apparently, Congress concluded that since it was precluding the transfer of built-in losses when there is a net built-in loss, it was only fair to remove the built-in gain of appreciated properties that were acquired by the corporation in the same transaction since the total amount of appreciation of such transferred properties is offset by an equal amount of depreciation of the other transferred properties. This statutory adjustment to basis applies for all purposes so that the new basis will be used to measure both gains and losses. The circumstance in which this provision applies is referred to as the "importation of a net built-in loss."⁵⁸

⁵⁶ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 836, 118 Stat. 1418, 1594-96 (2004).

⁵⁷ CHARLES E. GRASSLEY, JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT, S. REP. NO. 108-192, pt. 1, at IV-C1 (2003). The investigative report on the Enron Corporation was the source of Congress's attention to this issue. *Id.*

⁵⁸ I.R.C. § 362(e)(1)(A). Section 836(b) of the American Jobs Creation Act of 2004 adopted a similar provision for the circumstance where a domestic corporation receives property with a net built-in loss from a foreign corporation pursuant to a liquidation under section 332. Pub. L. No. 108-357, § 836, 118 Stat. 1418, 1594-96; see also I.R.C. § 334(b)(1)(B).

Subsection (e)(1) does not involve a duplication of loss, but rather involves the transfer of a depreciated asset from a person whose loss on the disposition of that asset would have no U.S. tax consequence to a domestic corporation that could use the loss as a deduction from its U.S. taxable income. The 2004 amendment prevents that importation of a built-in loss. However, a built-in loss can be transferred by a foreign person if the aggregate basis of the properties transferred by that person does not exceed the aggregate value of those properties. In that case, all of the built-in loss that is transferred is effectively offset by built-in gain that is transferred and there is no abuse.

B. Subsection (e)(2)

Congress was not concerned solely with transfers of built-in losses by foreign persons. The Senate Committee's Report to the 2004 Act states with regard to the adoption of section 362(e):

The Joint Committee on Taxation staff's investigative report of the Enron Corporation and other information reveal that taxpayers are engaging in various tax motivated transactions to duplicate a single economic loss and subsequently, deduct such loss more than once. Congress has previously taken actions to limit the ability of taxpayers to engage in specific transactions that purport to duplicate a single economic loss. However, new schemes that purport to duplicate losses continue to proliferate. . . . [T]he Committee believes that a single economic loss should not be deducted more than once. Thus, the Committee believes that it is generally appropriate to limit a corporation's basis in property acquired in a tax-free transfer to the fair market value of such property. In addition, the Committee believes that it is appropriate to prevent the importation of economic losses into the U.S. tax system if such losses arose prior to the assets becoming subject to the U.S. tax system.⁵⁹

Subsection (e)(2) deals only with transfers of depreciated property to a corporation either in a section 351 exchange or as a contribution from a shareholder to the corporation.⁶⁰ The general rule

⁵⁹ CHARLES E. GRASSLEY, JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT, S. REP. NO. 108-192, pt. 1, at IV-C1 (2003) (citation omitted).

⁶⁰ In this article, the authors focus on section 351 exchanges, but the same considerations apply to contributions made by a shareholder to a corporation's

is that a corporation's basis in property it acquired in a section 351 exchange or as a contribution to capital is the same as the basis that the transferor had in that property increased by any gain the transferor recognized.⁶¹ Subsection (e) establishes an exception to that determination of basis.⁶²

Subsection (e)(2) applies if the aggregate adjusted basis of the properties transferred by a transferor is greater than the aggregate fair market value of the transferred properties.⁶³ In that case, the corporation's basis in the transferred properties is reduced by that difference. This reduction of the corporation's basis is allocated among the depreciated transferred properties in proportion to their built-in loss immediately before the transfer took place. Thus, while the aggregate basis of the acquired properties will equal their aggregate fair market value, some of the properties can be appreciated and some can be depreciated. The corporation's new basis is used for all purposes, including to measure both gains and losses. The operation of subsection (e)(2) is illustrated in Part IV of this article.

However, in the case of a section 351 exchange, the corporation's basis in the transferred properties will not be reduced if the transferor and the corporation elect to have the transferor's basis in the stock received in the exchange limited to its fair market value immediately

capital. A shareholder's contribution to a corporation will increase the shareholder's basis in the stock of the corporation that the shareholder holds by the amount of the basis of the contributed property. I.R.C. § 1016(a)(1). If a person who is not a shareholder makes a contribution of property in kind to a corporation, the corporation will have a zero basis in the contributed property. I.R.C. § 362(c)(1).

⁶¹ I.R.C. § 362(a). See *supra* note 26.

⁶² I.R.C. § 362(e).

⁶³ The provision applies to each transferor separately rather than to the control group, if any, as a whole. As noted by Jasper Cummings and Robert Hanson:

Although there is some confusion on the point, it seems that the provision is to be applied to each separate transferor, even though several persons (the control group) may have transferred property in a section 351 exchange for control of the transferee corporation. The statute seems to say that fairly clearly. However, the Senate report stated that the rule applied only if the properties contributed by the control group in the aggregate carried a net built-in loss, and the conference report repeated that statement in describing the Senate bill and said that the Senate bill was followed with modifications but did not refer again to this issue.

Jasper L. Cummings, Jr. & Robert P. Hanson, *New Limitations on Corporate Built-In Losses*, 107 TAX NOTES 1553, 1562 (June 20, 2005).

after the exchange.⁶⁴ Thus, instead of reducing the corporation's basis in the transferred properties, the parties can elect to limit the transferor's basis in the stocks received in the exchange.⁶⁵ This election reflects that Congress was not concerned with the shifting of a potential loss from the transferor to the corporation, but was concerned exclusively with preventing the duplication of a loss deduction.

Example 2. *M*, a U.S. citizen, owned machinery having a fair market value of \$30,000 and subject to an encumbrance in the amount of \$10,000. Thus, the net value of the encumbered machinery was \$20,000. *M*'s basis in the machinery was \$40,000, so the machinery was depreciated property. *M* organized the *X* Corporation and transferred the machinery to *X* for 10 shares of *X*'s stock having a value of \$20,000. *X* took the machinery subject to the \$10,000 encumbrance. The exchange qualified for nonrecognition under section 351. If no election under section 362(e)(2)(C) were made, *M* would have a basis of \$30,000 in the 10 shares of *X* stock — i.e., *M*'s basis in the stock equals his \$40,000 basis in the machinery less the \$10,000 encumbrance on that property.⁶⁶ In the absence of an election, *X*'s \$40,000 basis in the machinery will be reduced by \$10,000 pursuant to section 362(e)(2), so *X* will have a \$30,000 basis in the machinery. Instead, *M* and *X* elect to limit *M*'s basis in the stock to its fair market value of \$20,000 pursuant to section 362(e)(2)(C). Because of the election, *X* will have a \$40,000 basis in the machinery and thus a \$10,000 built-in loss.

The operation of the section 362(e)(2)(C) election in the example above is consistent with the purpose of subsection (e)(2). Since the transferor's basis in the stock equals its fair market value, there will be no duplication of a built-in loss. Congress was not adverse to the shifting of the \$10,000 built-in loss from *M* to the *X* corporation, but only with preventing a duplication of the loss.

⁶⁴ I.R.C. § 362(e)(2)(C). The election is made by including it in the tax return for the taxable year in which the section 351 exchange took place. I.R.C. § 362(e)(2)(C)(ii).

⁶⁵ Guidance for the procedures for making this election is provided in I.R.S. Notice 2005-70, 2005-41 I.R.B. 694.

⁶⁶ I.R.C. § 358(a)(1), (d).

IV. THE FLAWS IN SECTION 336(D)(1)–(2) AND THE REASONS THESE PROVISIONS SHOULD BE REPEALED

Without regard to the effect of the 2004 adoption of section 362(e), the section 336(d)(1)–(2) provisions are poorly designed and operate badly. Even before section 362(e) was enacted, those provisions were flawed because there was no convincing rationale for the scope of their application — that is, there seems to be no meaningful distinction between liquidating distributions and related sales that are subject to those provisions and liquidating distributions and related sales that are not. After the adoption of section 362(e), the arbitrariness of those provisions remained; and, to make matters worse, there are circumstances in which the application of those limitations causes inequitable tax consequences that unfairly punish some taxpayers and other circumstances in which those limitations became moot.

A. Section 336(d)(2) — The Anti-Stuffing Provision

As already noted, the anti-stuffing provision of subsection (d)(2) applies only if a liquidation was anticipated at the time that the depreciated property was acquired by the corporation and, even then, only if a principal purpose of the acquisition was for the corporation to recognize the built-in loss in connection with the anticipated liquidation. The combination of a recognition of the built-in loss by the corporation and a liquidation of the corporation makes it likely that both the shareholder who transferred the property to the corporation and the corporation itself would recognize a loss for the same decline in value of the acquired property. However, if there were no plan to liquidate the acquiring corporation, but there was a plan to have the corporation recognize a loss by disposing of the depreciated asset or by utilizing larger depreciation deductions because of the excess basis in the asset, there would exist the same potential for doubling of the loss (i.e., a doubling of the use of the excess basis). The difference between the liquidation and nonliquidation circumstance is that, in the case of a liquidation, there is assurance that the shareholder will soon recognize the built-in loss. In contrast, if there is no liquidation planned, the shareholder would have to sell the acquired shares in order to recognize a loss or hold them until the corporation is liquidated. The potential difference in the timing of the transferor's recognition of the built-in loss does not appear to the authors to warrant providing such significantly different tax consequences.

Another flaw in the operation of subsection (d)(2) is that it does not bar the use of the excess basis (i.e., the excess of basis over value) to prevent the recognition of gain on appreciation of the depreciated property that takes place after the property was acquired by the corporation. While there is a difference between using excess basis to prevent gain recognition on the same asset and using it to create a loss deduction, there is reason to question whether that difference warrants such disparate tax treatment. It is noteworthy that section 362(e) reduces a depreciated property's basis for both gain and loss measurement purposes. However, subsection (d)(2) is not the only tax provision that disfavors loss recognition and permits offsets against appreciation. For example, when depreciated property is given to a donee, section 1015 prevents the donee from realizing the built-in loss, but permits the donee to use the excess basis to prevent the recognition of gain for subsequent appreciation of the donated property.⁶⁷

If the double allowance of a loss deduction was a loophole, it was not entirely closed by subsection (d)(2). Eight years after adopting subsection (d)(2), Congress added section 362(e) to the Code which addresses the doubling of loss deductions regardless of whether there was a plan to liquidate the corporation. There also is no time frame requirement in section 362(e) and it applies for purposes of measuring the amount of both gains and losses. In those respects, section 362(e) is a broader provision than subsection (d)(2); we will consider below whether it swallows subsection (d)(2) and renders it meaningless.

Not only is section 336(d)(2) limited to circumstances in which a plan of liquidation is contemplated, it will apply to relatively few such circumstances. Virtually no case in which a plan of liquidation is adopted more than two years after the corporation's acquisition of the depreciated property will be subject to the limitation.⁶⁸ Even when a plan is adopted within two years after the acquisition, there are numerous circumstances in which the limitation will not apply.⁶⁹ Congress was reluctant in 1986 to impose the (d)(2) type of limitation broadly; but, in 2004, Congress greatly expanded the reach of that

⁶⁷ However, in the case of section 1015, only one party (the donee) will use the excess basis.

⁶⁸ See H.R. REP. 99-841, pt. 3, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286; BLUE BOOK, *supra* note 24, at 343; *supra* text accompanying note 32.

⁶⁹ See H.R. REP. No. 99-841, pt. 3, at II-201 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286; BLUE BOOK, *supra* note 24, at 344; *supra* text accompanying note 31.

type of limitation when it adopted section 362(e). We will see that while the 2004 amendment to the Code did not render subsection (d)(2) meaningless, it did severely restrict the circumstances in which that limitation could have any consequence and caused subsection (d)(2) to impose harsh and inappropriate treatment in the few circumstances in which it continues to have an effect.

At first blush, it might seem that subsection (d)(2) could not have any impact once section 362(e) was adopted. To the contrary, there are two (and only two) circumstances in which subsection (d)(2) can still be of consequence. Let us first consider the effect that section 362(e)(2) has on the (d)(2) limitation. Consider the following illustration:

Example 3. *G*, a U.S. citizen, is the sole shareholder of the *Y* Corporation. *G* transferred Whiteacre (unimproved land) to *Y* in a section 351 exchange for 10 shares of *Y*'s common stock having a fair market value of \$100,000. *G* had a basis of \$210,000 in Whiteacre, which had a fair market value of \$100,000 at the time of the exchange. Under section 358, *G*'s basis in the 10 shares it acquired is \$210,000. While, in the absence of limitations, section 362(a) would provide *Y* with a basis of \$210,000 in Whiteacre, section 362(e)(2) will limit *Y*'s basis in Whiteacre to the property's fair market value of \$100,000. This limitation of *Y*'s basis in Whiteacre would not apply if an election were made under section 362(e)(2)(C) to limit *G*'s basis in the 10 shares of stock; but no election was made.⁷⁰ The \$100,000 basis that *Y* acquires in Whiteacre applies for all purposes so that it will not matter whether *Y* liquidates or whether the value of Whiteacre rises or falls. The effect of the section 362(e)(2) provision is to prevent the corporation from obtaining a tax benefit for a built-in loss obtained in a section 351 exchange while allowing the transferor to retain the built-in loss by transferring it to the stock that was received in the exchange. Thus, only a single tax benefit will be allowed for the built-in loss.

If a principal purpose of the section 351 exchange was for *Y*

⁷⁰ If *G* were a foreigner, *Y*'s basis in Whiteacre would be \$100,000; but, in that case, section 362(e)(1) would be the applicable provision and there would be no provision for an election to alter the transferor's stock basis in lieu of limiting the corporation's basis.

to recognize a loss in connection with a liquidation and if *Y* distributed Whiteacre to *G* as a liquidating distribution less than two years later, section 336(d)(2) would apply to limit *Y*'s basis in Whiteacre to \$100,000 for purposes of measuring any loss recognized by *Y* on the distribution; but section 362(e)(2) already established *Y*'s basis in Whiteacre at \$100,000, so the (d)(2) limitation is of no consequence.

Example 3 shows that if all the properties transferred by a shareholder to the corporation are depreciated and if no section 362(e)(2)(C) election is made, then section 336(d)(2) has no significance regardless of whether the transferor is a U.S. citizen or a foreigner. Section 336(d)(2) has no effect on the transaction. However, if the shareholder transferred a mix of both appreciated and depreciated properties to the corporation or if the parties make an election under section 362(e)(2)(C) to limit the basis of the shareholder's stock, then section 336(d)(2) can have an effect. Those are the only two circumstances in which subsection (d)(2) can have any significance. Examples 4 through 7 below illustrate how that occurs and why the consequences of applying subsection (d)(2) are undesirable.

Example 4. Assume the same facts as those stated in Example 3 except that *G* and *Y* elect under section 362(e)(2)(C) to limit *G*'s basis in the 10 shares of *Y* stock to their \$100,000 fair market value. In that case, if section 336(d)(2) does not apply, *Y*'s basis in Whiteacre will be \$210,000. The obvious purpose of allowing that election is to protect the goal of permitting only one deduction for a built-in loss while permitting the transferor to shift the loss deduction to the corporation. If *Y* sells Whiteacre for \$100,000 (its value), *Y* will recognize a loss of \$110,000 (\$210,000 basis minus the \$100,000 selling price). If *G* sells the 10 shares of *Y* stock for their value of \$100,000, *G* will not recognize a gain or loss.

What happens if *Y* liquidates within two years, sells Whiteacre at a time when the fair market value of Whiteacre is \$100,000, and if section 336(d)(2) is held to apply to that sale? Subsection (d)(2) would reduce *Y*'s basis in Whiteacre by the \$110,000 built-in loss. *Y* distributes the \$100,000 proceeds of that sale to *G*. Neither *Y* nor *G* would recognize

a gain or loss since *Y* has a \$100,000 basis in Whiteacre and *G* has a \$100,000 basis in the 10 shares of stock. The consequence of applying subsection (d)(2) is that neither the transferor *G* nor the *Y* Corporation recognizes a loss. The purpose of both section 336(d)(2) and 362(e)(2) is to prevent the doubling of a built-in loss deduction; they were not intended to prevent a single deduction of the loss. Given the existence of section 362(e)(2), the application of section 336(d)(2) causes a harsh and undesirable result.

One might contend that since subsection (d)(2) has a subjective element to it, the Service and courts should find that the transfer of property to a corporation cannot have the proscribed purpose if a section 362(e)(2)(C) election is made. But, the proscribed purpose is only to have the corporation recognize a loss in connection with a liquidation. There is no requirement that the purpose be to double the recognition of the loss or that the transaction have a tax avoidance motive. While the prevention of tax avoidance through doubling the recognition of a loss is the reason that Congress adopted subsection (d)(2), Congress did not expressly provide that the statute applies only if the transaction was motivated by tax avoidance or a plan for the double use of a property's built-in loss.

The fact that there will be only a single recognition of a loss because of the application of the section 362(e)(2)(C) election may influence a court or the Service to be more lenient in finding that the proscribed purpose was not present, but the literal language of the statute makes no provision for such treatment. Perhaps, the Service or a court will graft an exception to section 336(d)(2) when there is no double deduction at stake on the ground that such an exception is consistent with the policy for adopting the subsection (d)(2) limitation; but one cannot be confident that will occur.

In sum, when a section 362(e)(2)(C) election has been made, section 336(d)(2) is, at best, superfluous, and, at worst, harmful.

Another situation in which section 336(d)(2) can still have an effect is where a transferor transfers a mix of appreciated and depreciated assets to a corporation. Section 362(e)(2) reduces the basis of the depreciated assets the corporation acquired only by the net built-in loss — i.e., by the excess of the aggregate basis of the transferred assets over the aggregate fair market value of those assets. So, the basis of depreciated assets will not be reduced by that provision to the extent of the amount of aggregate appreciation in the appreciated assets that were transferred. If the aggregate amount of

appreciation equals or exceeds the aggregate amount of depreciation, there will be no reduction of the corporation's basis in the depreciated assets.

In contrast, section 336(d)(2) applies to each depreciated asset individually. So, a mix of appreciated and depreciated assets will have no effect on the reduction of basis for each depreciated asset if section 336(d)(2) applies. We will illustrate how that operates in several examples below and then we will consider whether it is undesirable for section 336(d)(2) to apply in those circumstances.

Example 5. In a section 351 exchange, *K* (a U.S. citizen) transferred properties to the *Z* Corporation in exchange for 100 shares of *Z*'s common stock having a fair market value of \$550,000. *K* is the sole shareholder of *Z*. There were five properties transferred by *K* to *Z* in that exchange. The five properties and their adjusted bases and values at the time of the exchange were:

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>
Land 1	\$80,000	\$100,000
Land 2	\$120,000	\$90,000
Building	\$200,000	\$130,000
Corporate Stocks	\$50,000	\$105,000
Patent	\$100,000	\$125,000
TOTAL	\$550,000	\$550,000

Since the aggregate basis of the properties transferred by *K* do not exceed the aggregate fair market value of those properties, section 362(e)(2) is not applicable; and *Z*'s basis in each of the five properties is the same as the basis that *K* had in those assets.

Even though the built-in loss of Land 2 and the Building was passed to the corporation, there is no tax abuse in this situation because the built-in losses are offset by the built-in gains that were transferred to *Z*. If *K* were to sell his 100 shares of *Z* stock for their value of \$550,000, he would not recognize a gain or loss since his basis in the stock also was \$550,000. *K*'s basis in the stock reflects the fact that the \$100,000 of built-in loss that he retained from Land 2 and the Building is offset by the \$100,000 of built-in gain that he also retained from Land 1, the Corporate Stocks, and the Patent. Similarly, *Z*'s acquisition of a \$100,000 built-in loss is offset by *Z*'s acquisition of \$100,000 of unrealized appreciation. While *Z* could promptly sell the

depreciated Land 2 and the Building (and thereby recognize a loss of \$100,000) and could continue to hold the other three properties so as not to recognize the unrealized appreciation of those properties, there still is no abuse in that situation because there is no overall doubling of a loss. The corporation's ability to accelerate the recognition of its loss while delaying the recognition of its gains is the same power that any taxpayer, who has a mix of appreciated and depreciated properties, possesses. There is no reason to regard Z's position any differently or to impose any special tax treatment on Z and the current version of section 362(e)(2) properly leaves the parties untouched.

One might question why the transfer of unrealized appreciation should offset the transfer of unrealized depreciation only if the transfers were made by the same transferor as part of the same transaction. For example, if K were to transfer appreciated property to Y corporation in Year One, and transfer depreciated property to Y in Year Three, the built-in loss of the depreciated property will cause a reduction of Y's basis in that property without any offset for appreciation of property previously or subsequently placed into the corporation by K. The apparent reason for not offsetting in that circumstance is administrative burden. While it would be possible to keep track of transfers of appreciated and depreciated properties that were made over a period of years by a single transferor, it would impose an administrative burden to do so. The burden would be especially heavy when appreciated property was transferred to the corporation after the reduced basis of previously contributed depreciated property had caused tax consequences (e.g., if the depreciated property had previously been sold or if depreciation deductions had been taken). If the change in basis caused by the offset of the appreciated property were to be applied retroactively, there could be difficulty in adjusting the tax consequences that were previously reported.

Example 6. Assume the same facts as those stated in Example 5. One year after the section 351 exchange took place, Z sold Land 2 and Building to an unrelated person and Z distributed the proceeds of that sale and the remaining three properties to K as liquidating distributions. The properties had the same values at the time of the sale and liquidation as they had one year earlier. Section 336(d)(2) could apply to the sale of Land 2 and the Building, depending upon the purpose the parties had for transferring the

properties to Z. If section 336(d)(2) applies, Z's basis in Land 2 will be reduced to \$90,000 and Z's basis in the Building will be reduced to \$130,000. Therefore Z will not realize or recognize any loss on the sale of those two properties. However, Z will recognize a gain of \$100,000 (total \$330,000 sales price minus the total \$230,000 basis) on the liquidating distribution of its other three properties. K will not recognize a gain or loss since the amount K received for his stock equaled the basis of the stock.

Congress made the decision in adopting section 362(e) to allow a corporation to deduct built-in losses acquired in a section 351 exchange to the extent that such built-in losses were offset by the acquisition of unrealized appreciation from the same transferor at the same time. There is no apparent justification for denying a corporation the recognition of such losses only when they are incurred in the context of a liquidation and then only in very limited circumstances. The continued existence of section 336(d)(2) provides no useful supplement to section 362(e) and actually contravenes the congressional scheme that section 362(e) reflects.

As noted in connection with the section 362(e)(2)(C) election, it is possible that the Service or a court will not apply the subsection (d)(2) provision in this circumstance. That possibility appears unlikely in this context, however, because there is a doubling of loss recognition when each depreciated asset is viewed individually — i.e., the congressional decision in subsection (d)(2) not to take into account a simultaneous transfer of appreciated property makes the presence of appreciated property and the treatment accorded it by section 362(e) irrelevant to the application of subsection (d)(2). In any event, if the courts were to exclude all transactions that fit within section 362(e) from the application of section 336(d)(2), there still would be no reason to retain subsection (d)(2) because it would have no circumstance in which it could be of consequence.

Example 7. Assume the same facts as those stated in Example 5 except that the fair market value of the corporate stocks that K transferred to Z is only \$75,000 instead of the \$105,000 stated in that example. The aggregate basis of the transferred assets will still be \$550,000. But the aggregate fair market value of the transferred assets will be only \$520,000. Since the aggregate basis exceeds the aggregate fair market value of the transferred properties by \$30,000, section 362(e)(2) requires that the aggregate basis of those assets be

reduced by that \$30,000 net built-in loss. The \$30,000 reduction of basis is allocated between Land 2 and the Building (the two depreciated assets) according to the amount of their built-in loss. The built-in loss of Land 2 is \$30,000 (i.e., that is the amount by which Land 2 is a depreciated asset) and the built-in loss of the Building is \$70,000, for a total built-in loss of \$100,000. So, 30% of the \$30,000 reduction is applied to Land 2 which therefore has a basis of \$111,000 (\$120,000 minus \$9,000). The remaining 70% of the \$30,000 reduction is applied to the building which therefore has a basis of \$179,000 (\$200,000 minus \$21,000). Note that section 362(e) does not make the basis of each of the corporation's assets equal its value. To the contrary, three of the corporation's five assets are appreciated and two are depreciated.

Congress chose in section 362(e)(2) to eliminate a loss deduction for a corporate transferee of depreciated property only to the extent that the section 351 exchange created the prospect for a *net* double deduction. However, if a plan of liquidation of the corporation is adopted within two years after the exchange, any loss the corporation realizes on depreciated property could be altered by section 336(d)(2). As noted above, this frustrates the path that Congress chose in section 362(e)(2); thus, section 336(d)(2) should be repealed to prevent its conflict with the operation of section 362(e). There is no reason to seek to cure this problem by amending section 336(d)(2) because that provision has consequence only in circumstances in which it conflicts with the policy of section 362(e).⁷¹

Example 8. Assume the same facts as those stated in Example 7 except that *K* is a foreign individual and thus is not subject to the U.S. tax. In this case, section 362(e)(1) is applicable rather than section 362(e)(2). Since there is a net built-in loss, section 362(e)(1) makes *Z*'s basis in each of the transferred properties equal to the fair market value of that property. Consequently, there is no unrealized appreciation or depreciation in *Z*'s hands. Section 336(d)(2) is of no consequence since there is no asset with a built-in loss in *Z*'s hands. However, if the aggregate unrealized appreciation of the properties that *K* transferred to *Z* equaled or exceeded

⁷¹ In their article on this topic, Randall, Spilker, and Werlhof also recommend the repeal of section 336(d)(2). Randall et al., *supra* note 48, at 32.

the aggregate unrealized depreciation of other properties that *K* transferred, section 362(e) would not apply. Section 336(d)(2) could then apply to the depreciated properties. As noted in the above discussion of Example 7, the application of section 336(d)(2) in that situation is inappropriate because it conflicts with an essential element of the policy underlying section 362(e).

B. The Disqualified Property Provision of Section 336(d)(1)

As previously discussed, the principal, and probably the exclusive, reason that Congress adopted the disqualified property limitation was to prevent the doubling of the recognition of a built-in loss that was transferred to a corporation as part of a section 351 exchange or a contribution to capital.⁷² For reasons set forth in Part II.C.2, the authors reject the suggestion that the disqualified property provision is also aimed at preventing the parties from deliberately undervaluing assets distributed in liquidation to related persons. While operating quite differently, the congressional purpose for the disqualified property provision is therefore the same as the purpose that led to the adoption of sections 336(d)(2) and 362(e)(2). Unlike those latter two provisions, the disqualified property provision does not require that the property transferred to the corporation have been depreciated at the time of the corporation's acquisition. It is sufficient that the property have been acquired in a section 351 exchange or contribution within five years of the liquidating distribution and that it be depreciated at the time of distribution to a related person.

This provision prevents the recognition of a loss that a corporation realized on making a liquidating distribution of depreciated disqualified property to a related person. The provision utilizes an objective standard for determining its applicability; the purposes and intentions of the parties do not matter.

The disqualified property provision is poorly designed to deal with the double loss recognition issue or, for that matter, to deal with any other issue one might imagine. The provision disallows a deduction for an asset's decline in value that took place in the hands of the liquidating corporation. It would be reasonable for Congress to deny a deduction for any loss incurred in making a liquidating distribution, as Congress did in section 311(a) for nonliquidating distributions. But, Congress chose to allow a corporation to deduct

⁷² See *supra* Part II.C.2.

losses recognized on making a liquidating distribution of depreciated property.⁷³ The limitations that Congress imposed on that deduction should reflect some rational policy, but none is apparent in the case of the disqualified property provision. There is no justification for denying a deduction for losses realized on the liquidating distribution of property that was not a depreciated asset⁷⁴ when it was acquired by the corporation. Even if an asset was depreciated at the time it was acquired by the corporation, there is no justification for denying a deduction for the loss attributable to further declines in value that occurred in the hands of the corporation. A decline in value of a corporate asset that occurs while the corporation holds that asset will cause a corresponding decline in the value of the shareholders' stock and will thus result in a double deduction; but the double deduction is not created by a transfer of a built-in loss — the evil at which the disqualified property provision is aimed.

If a corporation purchased an asset that subsequently became depreciated because of a decline in value, the corporation could recognize a loss by making a liquidating pro rata distribution of that asset. If, instead, the corporation acquired the asset in a section 351 exchange at a time when the asset's fair market value was no less than its basis, the corporation could not recognize a loss. There is no reason that the question of whether to allow a deduction for the loss incurred on its distribution to a related person should be resolved any differently from the treatment of a purchased asset. Consider the following illustrations:

Example 9. In Year One, the *X* Corporation acquired Land 1 and Land 2. *X* purchased Land 1 from an unrelated party for its fair market value and therefore *X*'s initial basis in Land 1 equaled its then fair market value. So, Land 1 was neither appreciated nor depreciated when *X* acquired it. *X* acquired Land 2 from a shareholder in a section 351 exchange. At the time that *X* acquired Land 2, its basis and fair market value were equal. So, Land 2 was neither an appreciated nor a depreciated asset when *X* acquired it.

In Year Four, *X* was liquidated and distributed all of its

⁷³ I.R.C. § 336(a).

⁷⁴ You will recall that the term "depreciated asset" refers to an asset whose basis is greater than its fair market value. See *supra* note 8.

assets, including Land 1 and Land 2, to its sole shareholder.⁷⁵ At that time, both Land 1 and Land 2 had depreciated in value, so *X* realized a loss on the distribution of both properties. *X* is permitted by the Code to recognize and deduct the loss it realized on the distribution of Land 1.⁷⁶ However, the disqualified property provision of section 336(d)(1) prevents the recognition of a loss on the distribution of Land 2 and thus denies *X* a deduction for the loss it realized on that distribution. There is no good reason why the distribution of Land 2 should be treated differently than the treatment accorded to the distribution of Land 1.

Example 10. In 1999, *Y* Corporation acquired Land 3 in a section 351 exchange. At the time of acquisition, *Y* obtained a basis of \$100,000 in Land 3 which had a fair market value of \$80,000.⁷⁷ So, Land 3 had depreciated in the amount of \$20,000. *Y* was liquidated in the year 2000 and *Y* distributed Land 3 to its sole shareholder. At the time of distribution, the fair market value of Land 3 was \$50,000 and *Y*'s basis in the property was still \$100,000. If section 336(d)(2) were to apply to the transaction, it would reduce *Y*'s basis to \$80,000, leaving *Y* with a \$30,000 loss on making the liquidating distribution. But, the disqualified property provision of section 336(d)(1) prevents *Y*'s recognition of any loss on the distribution, so *Y* will have no deduction. When subsections (d)(1)–(2) both apply to a liquidating distribution, subsection (d)(1) has priority.⁷⁸ There is no reason to disallow any more of *Y*'s loss than the \$20,000 that was built-in at the time that *Y* acquired the property. That is the amount that would be disallowed by section 336(d)(2) if it were applicable and it is the amount that would be disallowed by section 362(e)(2) if it were applicable to the year in question. The disqualified property provision denies recognition to too large an amount.

⁷⁵ Since the distributions were made to a sole shareholder, they were pro rata; and the pro rata requirement of section 336(d)(1) was satisfied.

⁷⁶ Section 267(a)(1) does not prevent a deduction of the recognized loss because that provision does not apply to losses recognized in a distribution made pursuant to the complete liquidation of a corporation.

⁷⁷ Since section 362(e)(2) was adopted in 2004, it does not apply to the 1999 acquisition of Land 3.

⁷⁸ See *supra* note 37 and accompanying text.

The disqualified property provision is an even worse provision than section 336(d)(2). The only circumstance in which it can be said to operate properly is when it denies recognition for that amount of net loss that is attributable to the net amount of depreciation that existed when the assets were acquired by the corporation. That amount of built-in net loss now, however, is dealt with by section 362(e)(2). So, the provision serves no useful purpose and often applies in circumstances where it reaches improper results. For example, in Example 6, if Z had distributed Land 2 and Building to K in liquidation, instead of selling those properties and distributing the proceeds, the disqualified property provision would have prevented Z from deducting its loss on that distribution even though Z would recognize a gain on its distribution of the other three properties. The disqualified property provision is worse than subsection (d)(2) because it can apply to a wider range of circumstances and therefore is capable of causing more mischief.

Section 362(e)(2) does not apply to a corporation's built-in loss that was acquired in a section 351 exchange if an election was made to limit the basis of the shareholder's stock or to the extent that there was a mix of appreciated and depreciated property acquired by the transferee corporation in the exchange.⁷⁹ The application of the disqualified property provision to built-in losses that section 362(e)(2) does not reach because of either of those exceptions is improper and harmful for the reasons spelled out in the discussion of section 336(d)(2) in Part IV.A above.

Independent of its conflict with part of the policy of section 362(e)(2), the disqualified property provision is poorly designed. To the extent that the disqualified property provision denies a deduction for built-in losses, there is a question as to why it should be restricted to distributions to related persons. In that respect, it can be seen as too narrow. To the extent that the disqualified property provision applies to anything other than built-in losses, it is too broad. The provision should be repealed.

C. The Pro Rata Provision of Section 336(d)(1)

The pro rata provision is not aimed at preventing the doubling of recognition of a loss. Superficially, its purpose appears to be to apply to corporate liquidations a more modest version of section 267(a)(1), which denies a deduction for a loss recognized on a sale or exchange

⁷⁹ See *supra* Part III.B.

between related persons.⁸⁰ The pro rata provision, however, is not simply a narrower and modified version of section 267(a)(1). To the contrary, it operates in a manner that bears no relation to section 267(a)(1) and is inconsistent with the likely reason that section 267(a)(1) was adopted.

The apparent purpose of section 267(a)(1) is to prevent the recognition of unrealized depreciation when the property remains in the hands of a person who bears a close relationship to the taxpayer. The realization of a loss generally requires, as a minimum, a separation of the property from the taxpayer. The underlying theory of section 267(a)(1) is that when depreciated property is sold to a related person, the separation is not sufficient to permit a loss deduction to be taken at that time. Stating it differently, the group of related persons is regarded as a single person for that purpose and no loss will be allowed so long as the property remains within that group. The loss deduction that is disallowed by section 267(a)(1) is not excluded permanently. Instead, the disallowed loss is deferred and can be used to offset gain that the transferee realizes on a subsequent disposition of the property.⁸¹ The deferral will be permanent if the property does not appreciate in value in the hands of the transferee since the disallowed loss can be used only to prevent gain recognition for appreciation that arises in the hands of the transferee. However, the statute does leave open the possibility that the disallowed loss will be utilized by the transferee at a later date.

Compare the operation of section 267(a)(1) with the pro rata provision. Under the latter provision, the corporation can recognize and deduct the loss that it realizes on making a liquidating distribution of depreciated property to a related person provided that the distribution constitutes the related person's proportionate share of the distributed property. If the liquidating distribution to the related person is greater or less than that person's proportionate share, then the distributing corporation will not recognize the loss it realized on that distribution. This provision has nothing to do with the separation of depreciated property from a group of related persons. There need be no separation of the property from the group so long as the related

⁸⁰ As previously noted, section 267(a)(1) does not apply to distributions made in complete liquidation of a corporation. The gain or loss realized on a liquidating distribution is equivalent to the gain or loss realized from a sale or exchange of property. See *supra* note 54 and accompanying text.

⁸¹ I.R.C. § 267(d). Only gain realized by the original transferee on a subsequent disposition of the transferred asset (or of certain replacement assets) can be excluded by section 267(d). Treas. Reg. §§ 1.267(d)-1(a)(3), (4), Exs. (1)-(4) (1960).

person receives his proportionate share of the distribution. This treatment conflicts with the section 267 purpose to disallow a deduction for a loss when ownership of the property remains within the group of related persons. The rationale for the adoption of section 267(a)(1) has no relevance to the adoption of the pro rata provision.

Moreover, if a liquidating distribution of depreciated property to a related person is not pro rata, then section 336(d)(1) permanently prevents any deduction for the corporation's loss. The shareholder's basis in the distributed property will equal its fair market value⁸² and any gain the shareholder may realize from subsequent appreciation of the property will be recognized unless realized in a nonrecognition transaction. There is no potential deferral of the disallowed loss. In that regard also, the pro rata provision is unlike section 267(a)(1). If, contrary to the authors' conclusion, a purpose of the pro rata provision is to emulate section 267(a)(1), it does a remarkably poor job of it.

What then could possibly be the congressional purpose for adopting the pro rata provision? In Part II.C.3, the authors suggest that the purpose of the provision is to remove the risk that the corporation and the related person would conspire to undervalue the property distributed to that person in order to provide a tax benefit to the distributing corporation. If that is the reason for the provision, it is difficult to see why the limitation does not apply to proportionate distributions. Indeed, to the extent that minority shareholders might be a check on a corporation's wish to undervalue a distribution to a related person, they would have no reason to object if all the shareholders received a proportionate share of the property. If the distributee is the sole shareholder of the corporation, the risk of undervaluation is even greater than that with disproportionate distributions; but the statute does not apply to the former situation. In short, if the provision is aimed at valuation issues, as the authors believe it to be, it nevertheless is badly designed.

We can only speculate as to the purpose of the pro rata provision. It is especially difficult to determine that purpose since the provision applies so imperfectly, and even irrationally, to any purpose one might choose for it. Regardless of what purpose the provision might have, it is badly designed and rife with arbitrary distinctions. The provision should be significantly revised or, preferably, repealed.

⁸² I.R.C. § 334(a).

V. TO WHAT EXTENT IS IT IMPROPER TO ALLOW TWO DEDUCTIONS FOR A SINGLE LOSS?

As previously noted, in a nonrecognition exchange between a corporation and another party, there typically will be a duplication of basis.⁸³ In the case of depreciated property, this results in a duplication of a built-in loss and therefore a potential duplication of a loss deduction. That is, both the corporation and the other party have the potential to utilize the excess basis. The manner in which this duplication occurs is described and illustrated in Part II.C. It is widely believed that the doubling of the use of the excess basis is an abuse. In that regard, note the paragraph from the conference report on the Tax Reform Act of 1986 quoted in Part II.C. As a consequence of that view, a number of provisions, including three of those described earlier in the article, have been adopted to prevent a duplication of the excess basis. An example of the commonly-held belief that this duplication of excess basis is an abuse is contained in a recommendation of the Joint Committee on Taxation in its investigative report on Enron to “curtail duplication of losses.” The recommendation stated “a single economic loss should not be deducted more than once. The Joint Committee staff recommends limiting a corporation’s basis in property acquired in a tax-free transfer (or reorganization) to its fair market value. . . .”⁸⁴ While this issue can arise in the context of other nonrecognition exchanges, we will focus exclusively on section 351 exchanges.

The effort of Congress to prevent the duplication of losses is based on an assumption that the duplication constitutes an abuse in all circumstances. The visceral reaction to a circumstance in which a double deduction is allowed is that it constitutes a tax loophole, so it is understandable that such a circumstance would be assumed to be a flaw that needs to be corrected. Let us now examine whether that assumption is well-founded.

To put this issue in context, note that a transfer to a corporation of appreciated property in a section 351 exchange will create a duplication of the built-in gain. The corporation will have a built-in

⁸³ See *supra* notes 4–9 and accompanying text.

⁸⁴ STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., ENRON: THE JOINT COMMITTEE ON TAXATION’S INVESTIGATIVE REPORT, at 85 (Joint Comm. Print 2003), available at <http://finance.senate.gov/hearings/89349.pdf>. As noted, this report led to the adoption of section 362(e). See CHARLES E. GRASSLEY, JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT, S. REP. NO. 108-192, pt. 1, at IV-C1 (2003); *supra* text accompanying note 57.

gain for the transferred property and the transferor will have a built-in gain for the stock that he acquired in exchange. What policy justification could there be for double taxing appreciation that arose in the hands of the transferor before the property was placed into corporate solution? The apparent justification is to conform the transaction to the principle that the incorporation of transferred property in a nonrecognition exchange generally should not alter the amount of gain that a sale of the property will produce — that is, the amount of income that the transferred assets will produce should not be altered when they are transferred to a corporation in a transaction that qualifies for nonrecognition of gain or loss. Similarly, the amount of gain that the transferor will recognize on a disposition of the corporation's stock should not differ from the amount of gain that the transferor would have recognized if he had sold the transferred property instead of incorporating it. These consequences are characteristic of the deferral element of nonrecognition provisions and reflect the underlying policies for the treatment of section 351 exchanges.

Should not the same tax treatment that applies to the transfer of appreciated property also apply to a transfer of depreciated property? The same principle that dictates that appreciated property should produce the same amount of gain in the hands of the corporate transferee will also dictate that depreciated property should produce the same amount of loss in the hands of the corporate transferee. The application of the same rules to both properties might be referred to as “parallel treatment.” But parallel tax treatment is not required in all situations; and there are numerous examples when it is not applied.⁸⁵ If, however, Congress chooses to apply a different set of rules to the transfer of depreciated property (i.e., nonparallel treatment), it should have a principled policy justification for that difference. One obvious consideration is that the government gains revenue by double taxing the transfer of appreciated property, but loses revenue if it allows a double loss. But revenue enhancement does not constitute a principled reason for disparate treatment and we need to look elsewhere for a principled policy justification.

The application of the basis carryover rules to permit the transfer of a built-in loss would be consistent with the treatment of a cash method taxpayer's transfer of a business, which includes accounts payable that will be deductible when paid, to a corporation in a

⁸⁵ See Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645 (2006).

section 351 exchange. The transfer of the accounts payable will not cause the transferor to recognize gain even if the amount of the accounts payable is greater than the transferor's basis in the assets he transferred.⁸⁶ Nevertheless, the transferee corporation will be permitted to deduct those accounts payable when it pays or accrues them.⁸⁷ The tax law permits the transfer of a deduction to the corporation and permits the double use of that deduction (once by the corporation and once effectively by the transferor in that it insulates the transferor from treating the liability as boot). This treatment is allowed because it is deemed consistent with one of the underlying purposes of section 351, which is to facilitate the incorporation of a business.

There are three possible justifications for treating a transfer of depreciated property differently from the transfer of appreciated property. The first two justifications, which are listed and discussed below, do not withstand scrutiny and do not justify the disparate treatment. The third justification does pose a problem that needs to be solved, but we shall see that the solution adopted by Congress is a case of overkill.

First, permitting the corporation to succeed to the excess basis that the transferor had in the property would permit the transfer of a potential deduction from one taxpayer (the transferor) to another (the corporation). Generally, the tax law frowns on the transfer of a built-in deduction to another taxpayer;⁸⁸ however, Congress has made it clear that it is not concerned about the transfer of the built-in loss to a corporation in a section 351 exchange. The principal statutory provision that addresses the double deduction problem is section 362(e)(2), described in Part III.B herein. Section 362(e)(2)(C) permits the parties to a section 351 exchange in which depreciated property has been transferred to the corporation to elect to limit the transferor's basis in the stock he received to its value and thereby permit the corporation to succeed to the built-in loss of the transferred property. Clearly, Congress was concerned about a

⁸⁶ I.R.C. § 357(c)(3). Moreover, the accounts payable will not cause a reduction of the transferor's basis in the stock he received in exchange. I.R.C. § 358(d)(2).

⁸⁷ Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 80-198, 1980-2 C.B. 113; I.R.S. Priv. Ltr. Rul. 200013044 (Mar. 31, 2000); I.R.S. Tech. Adv. Mem. 78-30-010 (Apr. 14, 1978). The Internal Revenue Service (Service) will treat the transaction differently if it is done for a tax avoidance purpose – i.e., if the transaction was not done primarily for a business purpose. I.R.S. Tech. Adv. Mem. 78-30-010 (Apr. 14, 1978).

⁸⁸ The limitation on a donee's use of excess basis in donated property is an illustration of the hostility to transferring built-in losses. See I.R.C. § 1015(a).

duplication of loss deductions, but not about the transfer of the loss deduction from the transferor to the corporation.

Another illustration that the tax law permits the transfer of deductions to a corporation in a section 351 exchange is the aforementioned treatment of a cash method taxpayer's transfer of accounts payable to a corporation.⁸⁹ The corporation is permitted to deduct the payment or accrual of those payables and the deduction is thereby transferred from the shareholder to the corporation. Moreover, as noted above, sections' 357(c)(3) and 358(d)(2) directive that accounts payables are not treated as liabilities for purposes of those two sections effectively allows the shareholder to utilize the deduction. The payable thus gives rise to two deductions — once for the corporation and once for the shareholder.⁹⁰

Second, putting the transferor's built-in loss in the corporation's hands allows the indirect benefits that shareholders obtain from the corporation's subsequent deduction to be shifted to other shareholders. If there were other shareholders at the time that the property was transferred to the corporation, the transfer of the built-in loss will benefit all of the shareholders proportionately when the loss is recognized and reduce corporate income. Some of the indirect benefit from the corporation's use of the built-in deduction will thus have been shifted to the other shareholders. Also, the contributing shareholder can sell his stock to a third party and thereby shift his share of the indirect benefit to the purchaser of the stock.

However, Congress has unequivocally demonstrated that it has no objection to such shifting of benefits. Congress expressly allows the transfer of a built-in loss to a corporation by permitting the parties to elect under section 362(e)(2)(C) to limit the transferor's basis in the stock he acquired in the exchange. This allows the corporation to obtain the transferor's basis in the transferred assets, which results in a transfer of the built-in loss in that asset. By permitting the transfer of the built-in loss to the corporation, Congress has allowed the shifting of the shareholder's indirect benefit of the corporation's deduction of that loss. Similarly, a shareholder's indirect benefit from a corporation's deduction of an account payable that was transferred to it by a cash method shareholder as part of a section 351 exchange can be shifted among shareholders. In addition, if the value of property that is owned by a corporation falls so that it becomes

⁸⁹ See *supra* note 87 and accompanying text.

⁹⁰ See Douglas A. Kahn & Dale A. Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461, 464 (1975).

depreciated property in the hands of the corporation, a shareholder generally can shift the indirect benefit of the corporation's deduction of that depreciated property by selling his stock before the deduction is recognized.

Perhaps, one reason that Congress allows the shifting of the indirect benefits that a shareholder can obtain from a corporation's receipt and recognition of a built-in loss is that such transfer does not affect the tax rate at which the corporation's benefit from the deduction is determined. The deduction is taken by the corporation at its marginal tax rate, so a shift of the shareholder's indirect benefits has no effect on the amount of tax reduction that the deduction will cause. The shift of the shareholder's indirect benefit from the corporation's deduction does not raise an issue concerning tax bracket differentials, because the deduction is taken by the corporation. Thus, the dollar amount of the benefit will be the same regardless of the identity of the shareholder. In that respect, this is quite different from the problem of shifting benefits in a partnership context where the benefit flows through to the partner at each partner's individual marginal tax rates.

Is there a reason to be concerned about a shift of the shareholder's indirect benefit? In our view, there is not. First, as noted above, the shift does not affect the tax rates at which the amount of dollar benefit from the corporation's deduction is determined. It affects only the identity of the persons who will indirectly enjoy the corporation's tax reduction. Secondly, except for specified circumstances that are dealt with in sections 382 through 384, the tax law generally has not shown concern about shifting among shareholders the indirect benefits from corporate tax attributes. For example, if an asset depreciates in the hands of a corporation, the indirect benefit of that corporate loss when realized usually can be shifted to others by a shareholder's sale of stock.⁹¹ In contrast, in the case of a partnership, Congress has adopted provisions to prevent certain shifting of tax consequences from one partner to another,⁹² but the concern there is over a reduction of tax rates since the partnership's tax consequences flow directly through to the partners. Even in the case of a partnership, a partner can shift most partnership tax benefits to another person by transferring his partnership interest.

⁹¹ In certain prescribed circumstances, sections 382 or 384 will affect the corporation's use of that tax benefit.

⁹² See, e.g., I.R.C. § 704(c). This provision prevents the shifting of a tax benefit or detriment from one person to another by means of contributing an appreciated or depreciated asset to a partnership.

Thus, even as to partnerships, the disposition of a partnership interest can result in a shifting of the tax attributes within the partnership. There is no reason to treat a shifting of the indirect consequences of corporate tax attributes more harshly.

Third, the availability of the doubling of the transferor's basis allows the transferor to make transfers of depreciated property to a corporation for the principal purpose of reducing the parties' overall tax liability. There is evidence that this vulnerability to manipulation is the source of Congress's decision to prevent the doubling of a net loss.⁹³ The concern over the potential for manipulation is legitimate. We shall explain below why we believe that a blanket prevention of the doubling of a net built-in loss is an excessively broad remedy and how a more finely tailored remedy could and should be substituted for the current provisions.

Let us begin with a few examples to see to what extent, if any, a taxpayer can improve his tax position by transferring depreciated property to a corporation if a duplication of loss is permitted. First, consider the tax consequences of holding a depreciated asset that is not transferred to a corporate entity. That situation is the base against which the tax treatment of a section 351 exchange is to be measured.

Example 11. *A*, a U.S. resident individual, holds Blackacre as an investment, or for use in his business, with an adjusted basis of \$100,000 and a fair market value of \$40,000. *A* sells Blackacre to an unrelated person for its fair market value of \$40,000 and thereby recognizes a loss of \$60,000 (\$100,000 basis minus the \$40,000 selling price). The \$40,000 that *A* received is not taxable since it is a return of capital. The \$60,000 loss will constitute a deductible loss. We will ignore the character of the loss. The character will affect the type of income it can offset, but regardless it can offset some type of income; and we will assume that the taxpayer has income from which the loss can be deducted. The \$60,000 loss deduction will insulate \$60,000 of income of the proper character. Therefore, the end result is that *A* will receive \$100,000 tax-free (\$40,000 from the sale and \$60,000 insulated income that he receives). Alternatively, if Blackacre is depreciable (for example, an improvement on leased land) *A* could take the \$100,000 of depreciation over a period of years and thereby insulate \$100,000 of income. In either case, *A*

⁹³ See *supra* note 84 and accompanying text.

ends up with \$100,000 of cash after-tax.

Now let us consider what the differences in tax consequences to *A* would be if *A* contributes Blackacre to a corporation in a section 351 exchange. To simplify the calculations in both examples below, *A* will be the sole shareholder of the corporation. In both examples, we will assume that none of the Code sections dealing with double losses has been adopted; this way, we can see what the consequence of the double loss would be if no statutory restriction existed. We will assume that the built-in loss of any property will be utilized to create deductions that will offset income, because it is only when a built-in loss is utilized to prevent the taxation of income that it might become objectionable.

Example 12. Assume the same facts as those stated in Example 11 except that *A* creates the *X* Corporation and transfers Blackacre and other property to *X* in exchange for all of *X*'s stock. *A*'s basis in each of the other assets is equal to the fair market value of that property — i.e., the properties other than Blackacre are neither appreciated nor depreciated. *A*'s basis in the stock that he receives in the exchange for Blackacre will be \$100,000, the same basis that he had in Blackacre. Since we are excluding section 362(e) from the problem, *X*'s basis in Blackacre will also be \$100,000. The corporation can sell Blackacre for its fair market value of \$40,000 and thereby recognize a loss of \$60,000. The \$60,000 deductible loss can offset \$60,000 of income that the corporation earns. As a consequence, the corporation will have \$100,000 free of tax — i.e., it is in the identical position that *A* was in Example 11. *X* liquidates and distributes the \$100,000 to *A* in exchange for the stock that *A* received for Blackacre.⁹⁴ *A* receives the \$100,000 cash and recognizes

⁹⁴ Of course, if *X* liquidates, it must distribute all its assets. In the interest of simplification, let us assume that *A* has previously disposed of all of his stock except the shares that he received in exchange for Blackacre. It would not change the result if *A* held all of his stock, but it would complicate the calculations without changing the involved principle.

While the \$60,000 of income that *X* recognized will be added to its earnings and profits account, the \$60,000 loss that *X* recognized on the sale of Blackacre will reduce its earnings and profits. Consequently, unless *X* has other earnings, it will have zero earnings and profits. If *X* does not liquidate and instead distributes \$100,000 cash to *A* as a distribution on his stock, *A* will not recognize income from the receipt of that distribution since *X* has no earnings or profits. Instead, *A*'s basis in his

neither a gain nor loss since his basis in the stock is also \$100,000. At the end of the day, *A* is in the identical position that he occupied in Example 11. That is, he has \$100,000 cash after-tax.

Clearly, *A*'s situation in Example 12 is not abusive since he gained no advantage from the duplication of deductions. To the contrary, if *X* were denied the use of the excess basis — for example, if *X* were limited to a basis equal to its fair market value of \$40,000 as currently provided by section 362(e)(2), or if, instead, *A* and *X* elect under section 362(e)(2)(C) to limit *A*'s basis in his *X* stock to its fair market value — *A*'s transfer of Blackacre to the corporation would put *A* in a worse position than if *A* did not make the transfer. That leads to a perverse parallel treatment in that *A* will be worse off from a tax cost position if he transfers to a corporation either an appreciated or depreciated asset. It is capricious to apply a different set of rules for the transfer of a depreciated asset in order to ensure that the taxpayer will suffer a detriment.

There is, however, a circumstance in which the doubling of the excess basis has consequences that raise legitimate concerns. This occurs when the assets that produced the income against which the deduction of the built-in loss was offset were not contributed by the transferor as part of the same transaction in which he contributed the depreciated asset to the corporation.

Example 13. In Year One, *A* created the *X* Corporation and transferred Greenacre, with a value and basis of \$40,000, to *X* in exchange for all of *X*'s stock. By Year Four, Greenacre's value had risen to \$100,000 and *X* still had a basis of \$40,000 in that property. In Year Four, *A* owned Blackacre with a value of \$40,000 and *A* had a basis of \$100,000 in that property. Let us consider two alternative scenarios.

(1) Suppose that *A* transfers Blackacre to *X* in exchange for additional shares of *X*'s stock. Let us assume that the exchange qualifies as a section 351 exchange despite the likelihood that the transfer of Blackacre has no business purpose. Remember that we are assuming that the facts of these examples precede the adoption of section 362(e)(2),

X stock will be reduced by \$100,000. So the tax consequence to *A* will be the same whether *X* liquidates or instead distributes its \$100,000 of cash to *A*.

which therefore is not applicable to any of these examples. *X* then sells Blackacre for its value of \$40,000 and Greenacre for its value of \$100,000. The \$60,000 gain (\$100,000 selling price minus the \$40,000 basis) that *X* recognized on the sale of Greenacre is offset by the \$60,000 loss (\$100,000 basis minus the \$40,000 selling price) *X* recognized on the sale of Blackacre. *X* therefore has \$140,000 (the combined selling price) cash free of tax. *X* then distributes the \$140,000 cash to *A* as a liquidating distribution. *A* will not recognize any income on that distribution since his basis in his *X* stock is \$140,000. So, *A* ends up with \$140,000 cash free of tax from the sales of Blackacre and Greenacre.

(2) Suppose instead that *A* does not transfer Blackacre to *X*. *X* sells Greenacre for its value and recognizes a gain of \$60,000 (\$100,000 selling price minus the \$40,000 basis). Since *X* has no losses to offset against that gain, *X* will pay a tax on its gain. For convenience, let us assume that the tax on that gain is \$20,000. After paying the tax, *X* liquidates and distributes the \$80,000 remaining proceeds to *A* (that is, \$100,000 selling proceeds minus the \$20,000 tax). *A* recognizes a gain of \$40,000 (\$80,000 proceeds minus the \$40,000 basis) on that distribution since his basis in his *X* stock is \$40,000. In the same year, *X* sells Blackacre for a \$60,000 loss. The deduction of that loss will offset the \$40,000 gain that *A* recognized on his *X* stock, so *A* will pay no tax on that gain. The remaining \$20,000 of the loss on Blackacre can offset \$20,000 of other income that *A* has. The end result is that *A* will have \$140,000 cash free of tax (\$80,000 from the liquidation of *X*, \$40,000 from the sale of Blackacre for its value, and \$20,000 of other income that is not taxed because of the loss *A* incurred on the sale of Blackacre). That is the same amount of cash that *A* obtained in the first illustration above, but in this illustration, the \$140,000 is not derived exclusively from the sale of Greenacre and Blackacre. An additional \$20,000 had to be obtained from other income. The reason for the difference is that the contribution of Blackacre to *X* insulated *X* from recognizing income on the sale of Greenacre, on which *X* will be taxed if Blackacre is not added to *X*'s assets.

There is a question as to whether the insulation from taxation of *X*'s gain on Greenacre is abusive. If Blackacre were transferred to *X* for valid business reasons, then the insulation is consistent with the structure of the section 351 exchange in which basis is duplicated to maintain the same built-in gain or loss both for the transferred assets and for the transferor that would have been incurred if no transfer had taken place. If Blackacre had been contributed to *X* before it depreciated in value so that the depreciation had taken place in the hands of the corporation, *X* could utilize the loss recognized on the sale of that property; *A* would have the same amount of loss on his stock; and there would be no objection to the double use of that deduction. Why then is it objectionable when the decline in Blackacre's value took place in the hands of *A*? It seems to the authors that the objection centers on the potential for a manipulative transfer of depreciated assets to be made for the principal purpose of doubling the use of the excess basis.⁹⁵ If, instead, the depreciated property were transferred primarily for a business purpose, the doubling of the use of the excess basis would merely be an element of the system adopted for the treatment of section 351 exchanges and does not warrant any restrictive treatment. Again, recall that a cash method taxpayer's transfer of an account payable to a corporation permits both the transferor and the corporation to use the deduction for the payment of the payable provided that the exchange was made for a business purpose.⁹⁶ The doubling of a deduction is no stranger to section 351 exchanges and is consistent with the policies underlying that provision.

In that regard, note that if a cash method taxpayer transfers a business with both accounts receivable and accounts payable to a corporation in a section 351 exchange, the Service does not apply the assignment of income doctrine to the receivables and allows the corporate transferee to deduct the payables when paid or accrued unless the exchange was done for a tax avoidance purpose. So long as the section 351 exchange had a business purpose, the principles of section 351 override other tax rules.⁹⁷ This is an example of allowing section 351 principles to control in most circumstances and targeting

⁹⁵ Even in that case, as reflected in the section 362(e)(2)(C) election, Congress is willing to allow either the transferor or the corporation to utilize the excess basis, but not both.

⁹⁶ See I.R.C. §§ 357(c)(3), 358(d)(2); Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 80-198, 1980-2 C.B. 113; I.R.S. Priv. Ltr. Rul. 200013044 (Mar. 31, 2000); I.R.S. Tech. Adv. Mem. 78-30-010 (Apr. 14, 1978); *supra* text accompanying notes 86-87.

⁹⁷ Rev. Rul 80-198, 1980-2 C.B. 113.

abusive, tax-avoidance transactions for special treatment, rather than allowing the possibility of tax avoidance to interfere with the avowed purpose of facilitating incorporating transfers made for a legitimate non-tax purpose.

The doubling of gain is a cost of contributing appreciated property. Whatever justification there may be for doubling the taxation of income arising in the hands of the corporation, the only justification for doubling the taxation of the built-in gain on contributed appreciated property is the goal of seeing that the same amount of gain is produced by the contributed assets and is borne by the transferors as would have been produced if the assets had been retained by the transferors. That same principle applies equally to built-in losses unless the parties are abusing the tax system by stuffing depreciated properties into the corporation for the principal purpose of reducing tax liability.

The authors agree that it is appropriate for Congress to prevent manipulation of ownership for the principal purpose of doubling a deduction. However, the principal statutory provision aimed at that problem, section 362(e)(2), is overly broad. It improperly applies to situations such as the ones described in Examples 12 and 13 even when the transferor's principal reason for contributing the depreciated asset to the corporation was non-tax profit motivated. Section 362(e)(2) should be limited to circumstances in which the facts indicate that the principal purpose of the transfer of the depreciated asset was income tax avoidance.⁹⁸

There is authority that a condition of qualifying an exchange with a corporation for section 351 treatment is that a bona fide purpose of the exchange be a non-tax business purpose.⁹⁹ It seems likely that

⁹⁸ That is the position that the Service adopted for section 351 transfers of accounts receivable and accounts payable. See Rev. Rul. 80-198; *supra* text accompanying note 87. Moreover, in discussing the adoption of section 336(d)(2), the Conference Report on the Tax Reform Act of 1986 indicated that the prohibition in that provision of a corporate transferee's utilization of a deduction for a built-in loss that was acquired in a section 351 exchange does not apply when the transfer to the corporation of the depreciated asset was made for a bona fide business purpose. H.R. Rep. No. 99-841, pt. 3, at II-201 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286. See also Yin, *supra* note 16, at 625 (suggesting that it was an error for Congress to have failed to provide a business purpose exception to the application of the disqualified property provision of section 336(d)(1)).

⁹⁹ Estate of Kleuner v. Commissioner, 154 F.3d 630 (6th Cir. 1998); Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), *aff'd on a different issue*, 865 F.2d 644 (5th Cir. 1989); 2001 FSA WL 961301 (Aug. 24, 2001); 2000 FSA WL 1930524 (May 19, 2000). See BITTKER & EUSTICE, *supra* note 24, at ¶ 3.17(6); KAHN

when there is a manipulative tax purpose for making a transfer to a corporation of a depreciated asset, that purpose will be evident in most cases, and especially so when the depreciated asset is sold soon after the corporation acquires it. Consequently, the abusive use of the doubling of excess basis rule will not be possible because the exchange with the corporation will not qualify for section 351 treatment (or for the accompanying basis rules).

If Congress is concerned that a business purpose rule will not be adopted by some courts, it could address that issue by expressly adding that requirement to section 351. That approach would attack a narrow problem with a scalpel rather than with an axe. If Congress is concerned that the vagaries of factual determinations may permit too many taxpayers to establish a business purpose when none actually exists, Congress could impose a greater burden of proof on taxpayers on that issue or create a rebuttable presumption that if a transferred depreciated asset is sold by the corporation within some specified time period, such as two years, the transfer to the corporation will be presumed to be tax motivated.

In addition to the business purpose rule, there are other grounds on which the Service can challenge the transferee corporation's deduction for a recognition of the built-in loss. If the transferee corporation is a controlled entity (i.e., either controlled by the transferor or if both the transferor and the transferee are controlled by the same interests), the Service could invoke section 482 to deny the transferee corporation a deduction for the amount of loss it recognized on a disposition of the depreciated item to the extent it equaled the built-in loss.¹⁰⁰ However, if the application of section 482 is merely to allocate the loss deduction to the transferor, and if that allocation does not reduce the transferor's basis in the transferee corporation's stock, the allocation will not prevent a duplication of the loss deduction; it will merely provide the transferor with two deductions instead of splitting them between the two parties. In appropriate circumstances, the Service might be able to invoke section 269(a) to deny anyone a deduction for the loss recognized on the disposition of the depreciated property to the extent it equaled the built-in loss if the principal purpose of the transfer was evasion or avoidance of the federal income tax and if the exchange conformed to

& LEHMAN, *supra* note 2, at 625–26.

¹⁰⁰ Treas. Reg. § 1.482-1(f)(1)(iii) (1994). See *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943).

the requirements of section 269(a)(1) or (2).¹⁰¹

Alternatively, the Service could seek to disregard the transfer of the depreciated property to the corporation on the ground that the transaction lacks economic substance. A sham transaction has been defined as one that: (1) has no business purpose other than obtaining tax benefits; and (2) has no economic substance because no reasonable prospect of profit exists.¹⁰² In the view of the authors, the business purpose requirement is an adequate ground for denying the transferee a deduction for the built-in loss, but the Commissioner has additional strings to his bow if he chooses to employ them.

In sum, the duplication of the use of excess net basis is appropriate to provide the same tax consequences to the disposition of the transferred assets and to the transferor that would have occurred if the depreciated property has not been put into corporate solution. There is potential for a taxpayer to abuse that treatment, but that potential can be virtually eliminated by enforcing the requirement that a non-tax business purpose be a principal reason that depreciated property was transferred to the corporation. The effectiveness of that limitation can be strengthened by imposing on the taxpayer a greater burden of proof as to the business purpose requirement and by establishing a presumption of tax avoidance purpose if the depreciated property is sold soon after the corporation acquires it.

VI. CONCLUSION

In the first several parts of this article, we reviewed the operation and possible justifications for section 336(d)(1)–(2), provisions that limit the use of corporate losses in certain circumstances connected with a corporate liquidation. As noted in the article, those provisions were seriously flawed from their inception; but the situation worsened with the recent passage of section 362(e)(2) which prevents the duplication of the use of net built-in losses. As demonstrated in the article, the passage of section 362(e)(2) makes the limitations set out in section 336(d)(1)–(2) superfluous at best and contradictory to the policies of section 362(e)(2) at worst. Those provisions should be repealed.

In Part V, we have questioned whether there should be a blanket

¹⁰¹ See I.R.S. Notice 2001-17, 2001-1 C.B. 730.

¹⁰² *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). See I.R.S. Notice 2001-17, 2001-1 C.B. 730.

provision preventing the duplication of a net loss and whether the problem at which that prohibition is aimed is much narrower than the scope of section 362(e)(2) would suggest. We propose that a narrower and more specifically tailored limitation should be substituted for the current provisions. This is a more disputable issue than is the narrower question of whether section 336(d)(1)–(2) should be repealed. A reasonable person could conclude, contrary to the authors' conclusion, that the difficulty of preventing an abusive use of the double basis rules to reduce taxes is so great that it is better to have a blanket prohibition of any doubling of excess basis. In our view, that remedy is too broad, causes inequitable consequences in some cases, and conflicts with the underlying policy of section 351 to facilitate the transfer of assets to a controlled corporation in order to create a more efficient business structure.

To the extent that there is potential for taxpayers to stuff depreciated properties in a corporation principally for tax reduction purposes, that potential can be addressed and prevented without eliminating the duplication in the many circumstances where there are legitimate reasons for allowing it. In other words, the various solutions that Congress has adopted do not address a problem that needs to be solved.¹⁰³ We hope this article, especially Part V, will dispel the illusion that there are giants to be slain and show Congress that in passing provisions like sections 336(d) and 362(e)(2), they are merely attacking windmills.

¹⁰³ Our reasoning has no bearing on the worthiness of section 362(e)(1).