The Repeal Of General Utilities: Estate Tax Implications

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Corporate distribution of appreciated assets to shareholders will now result in recognition of corporate gain

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The story begins with the Supreme Court's decision in *General Utilities & Operating Co. vs. Helvering*, 296 U.S. 200 (1935). The court held in *General Utilities* that a distribution by a corporation of appreciated assets to its shareholders did not result in a taxable gain to the corporation. Congress subsequently adopted this non-recognition rule in the handful of code sections dealing with corporate distributions. The non-recognition principle underlying these code sections has been popularly referred to as the "*General Utilities* doctrine."

Although Congress as well as the courts created various exceptions to the doctrine over the years, the doctrine has remained largely intact. In the 1986 Act (the Act), however, Congress repealed the doctrine. Consequently, corporate distributions of appreciated assets to shareholders will now result in the recognition of a corporate gain.

The purpose of this article is to examine the implications of the repeal of the *General Utilities* doctrine in the context of estate-tax valuation.

Before the Act

To commence, a review of the pre-Act tax rules is appropriate. A shareholder's sale of stock would not trigger a corporate tax on the appreciation inherent in the corporate assets — a rule not changed by the Act. The purchaser's cost would determine the basis in the acquired stock. If the purchaser were to then liquidate the corporation, the aggregate basis to the purchaser for all of the assets received as a result of the liquidation would, as a practical matter, equal the amount paid for the stock.[1] And the liquidation of the corporation in this fashion by the purchaser would not produce any corporate tax.[2]

Similar treatment was available when a corporation sold its assets and then liquidated within one year: The purchaser would have a basis equal to cost; the corporation would, as a general matter, not be subject to tax on the sale;[3] and the shareholder of the liquidating corporation would be taxable on his or her gain.

After the Act

The 1986 Act radically changes the tax rules in the corporate-liquidation context. The Act repeals the section 337 rule that sales made within one year of liquidation were not taxable to the corporation.[4] The Act also alters section 336 to provide that a corporation must recognize gain or loss on all of its assets at the time of liquidation as if the corporation had sold its assets at fair market value.[5] Thus, under the Act, the withdrawal of assets from corporate solution will, as a general matter, produce a corporate tax on the gain inherent in the corporation's assets.[6]

Given that the new corporate tax on liquidations is only imposed upon the withdrawal of assets from corporate solution, the purchaser is, in effect, given an election: 1) to leave the assets in the acquired corporation, which would produce no corporate tax, or 2) to liquidate the corporation and thereby withdraw the assets from the corporation, which would produce a corporate tax on all appreciation inherent in the corporation's assets.[7] If the second option is elected, the purchaser would enjoy a basis in the acquired assets equal to the cost incurred in acquiring the stock. On the other hand, if the first option is elected, the assets, of course, remain in the corporation and the corporation's basis in the assets remains what it was prior to the acquisition.

In the case of an acquired corporation having appreciated assets, the purchaser would be anxious to withdraw the assets from corporate solution in order to secure a basis equal to the amount paid for the stock in the acquired corporation — a basis that would be higher than the corporation's basis in the assets. But the desire to liquidate the acquired corporation for the purpose of increasing basis must be weighed against the corporate tax cost incurred by reason of the liquidation. Because under prior law no corporate tax was imposed as a general matter at the time of liquidation, the decision to liquidate was in many cases made as a matter of course.

Under the Act, however, purchasers will be deterred by the corporate tax from liquidating. Each dollar of basis increase generated by the liquidation will trigger a dollar of taxable income to the corporation at the time of liquidation. Obviously, the present value of the tax benefits inherent in a dollar of basis increase will never be greater than — and indeed will almost always be less than — the 34 cents of tax payment required to be made by the corporation at the time of liquidation (assuming a corporate tax rate of 34 percent).

The disinclination of purchasers to liquidate under the Act will have an impact on the negotiations of the purchase price. For example, assume that an investor is interested in purchasing an improved parcel of real estate. The seller's asking price is $1 million. If the investor pays $1 million, the investor's basis in the real estate would be $1 million. If, however, the real estate were owned by a corporation and its basis in the real estate were only $500,000 (either because the building has been depreciated or because it has appreciated in value), the investor would be willing to pay $1 million for the real estate, but something less for the stock in the corporation. The investor's willingness to pay more for the real estate than for the stock is probably attributable to the depreciation deduction he anticipates enjoying. The investor would prefer to take the depreciation deductions on a basis of $1 million dollars than on the corporation's basis of $500,000.[8]

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Indeed, the investor would probably tell the seller that, unless the seller compensated the investor for the investor's willingness to accept a basis of $500,000, the investor would buy a comparable piece of real estate for $1 million, in which he would enjoy a basis of $1 million. By this point in the negotiation, the seller should recognize that he would be in a much better position if he, as opposed to the corporation, owned the real estate and that the presence of the corporation diminishes the value of his asset.

At this juncture, the investor might offer to pay $830,000 for all of the stock in the corporation. After purchasing the stock, the investor could liquidate the corporation and thereby receive a basis in the real estate of $1 million. Of course, the liquidation would trigger a corporate tax of $170,000 (corporate tax rate of 34 percent imposed upon the appreciation of $500,000).[9] If the seller accepts the offer, the purchaser will have incurred an out-of-pocket cost of $1 million and will enjoy a basis in the real estate of $1 million.

If the seller is well advised, he will point out that a portion of the purchase price is attributable to the land and, therefore, not subject to depreciation. He will also point out that the depreciation deduction is not immediately available, but must be spread over a period of years. The investor would reply that though the portion of the basis attributable to the land is not depreciable, the basis in the land would certainly be significant should the investor decide to sell the property at some point. The seller should then offer to reduce the $1 million asking price by the present value of the forgone tax benefits inherent in a $500,000 basis. An exact quantification of the present value of the forgone tax benefit would, however, be impossible: Future tax rates are difficult to predict; whether, and if so, when, the investor might sell the property might well be impossible to forecast as well.

Some Observations

A few observations about this negotiation can be made. The investor would not be willing to pay $1 million for the stock unless the seller agreed to pay the tax cost inherent in a liquidation. The present value of the forgone tax benefit will in all probability be less than the tax that would be imposed were the corporation to liquidate. The investor would probably be willing to accept as a price reduction the present value of the forgone tax benefit, though the calculation required may well be difficult.

Thus, the 1986 Act's elimination of the possibility of liquidating a corporation on a tax-free basis impacts negatively on the value of corporate stock.[10] In valuing corporate stock for estate-tax purposes, will the IRS and the courts factor into the equation this negative impact? In other words, will a discount be permitted for diminution in value attributable to the imposition of a tax at liquidation?

Assets are included in the gross estate for estate tax purposes at fair market value. Recognizing that the measurement of fair market value is necessarily inexact, the courts and the Service have sought to elucidate the principles involved. Depending on the business of the corporation under inquiry, different valuation approaches are emphasized. Thus, the valuation techniques used for an operating company are different from those used for an investment-holding company: In the former case, the earnings capacity of the company is most often crucial, whereas the value of the corporation's assets in the hands of the shareholders following a hypothetical liquidation is generally the guiding principle in the latter case.[11]

As one hypothesizes a liquidation in order to value stock in a holding company, the question becomes whether the costs of such a liquidation should be permitted as a discount. More specifically, the issue here is whether the corporate tax imposed at liquidation on the appreciation in corporate assets is a cost for which a reduction or discount in value is appropriate.

The notion that great weight should be given to the value of the corporation's underlying assets in the context of a holding or investment company is set forth in Revs. Rul. 59-60. There, in discussing the appropriate valuation technique for such companies, the Service indicated that the costs of liquidation "merit consideration."[12]

One might infer from this ruling that a corporate income tax that would be imposed on appreciation in the event of a liquidation should be viewed as a cost of liquidation and therefore entitled to appropriate consideration in the valuation process.But the courts have for the most part been reluctant to permit a discount for such costs.[13] Essentially, the courts have reasoned that the liability to make payment of corporate tax on the appreciation inherent in corporate assets is either speculative (i.e., dependent upon corporate sales that may or may not be made) or indeed very unlikely to accrue (i.e., the corporation might well be liquidated on a tax-free basis or might never be liquidated). While this reasoning will be examined in light of the repeal of *General Utilities*, the cases should first be reviewed.

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Reducing Value

In *Estate of Piper vs. Commissioner*, 72 T.C.1062 (1979), the taxpayer argued that the value of the stock in the holding company at issue should be reduced for the potential capital gains tax the corporation would be required to pay were a liquidation to occur. The court refused to permit a discount for such a tax:

> We consider such a discount unwarranted under the net asset valuation technique employed herein, where there is no evidence that a liquidation of the investment companies was planned or that it could not have been accomplished without incurring a capital gains tax at the corporate level (72 T.C. at 1087).

In a footnote, the court explained that the corporate tax could be avoided either by the use of section 337, as then in effect, or by the use of the predecessor of section 338 (section 334 (b)(2)). The footnote suggests that, in the absence of these techniques permitting tax-free liquidation, the court would have been inclined to allow a discount for the corporate tax. The excerpt from the text of the decision, however, may point in a different direction. The text indicates that the court relied upon not merely the availability of the tax-free technique, but also the taxpayer's failure to prove that a liquidation could be anticipated.

Did the court intend to suggest that if a liquidation were taxable, a discount should not be permitted unless proof of an anticipated liquidation is present? In articulating two grounds for denying a discount — availability of tax-free techniques and the absence of proof that a liquidation was planned — the court did not clarify what its position would be if one of these grounds were removed. In other words, we can only speculate whether the court would permit a discount where the tax-free techniques are repealed, as has occurred, and there is no proof of an anticipated liquidation.

In *Estate of Thalheimer vs. Commissioner*, T.C. Memo, 1974-203, *aff'd.* 532 F.2d 751 (4th Cir. 1976), which was cited in *Piper*, the court denied a discount for tax solely on the basis that there was no evidence of a planned liquidation:

> The record clearly shows that ATAPCO is a diverse, viable going concern and there is no evidence of a plan for its liquidation, voluntary or otherwise. Under these circumstances, the discounts applied by petitioners' expert in ascertaining underlying net asset value per share of class A and class B ATAPCO common stock were inappropriate and improper.

Other Cases

Other cases cited by *Piper* where a discount was denied also placed heavy reliance on the absence of proof that a liquidation had been planned. See *Gallun vs. Commissioner*, T.C. Memo 1974-284; and *McTighe vs. Commissioner*, T.C. Memo 1977-410.

The concern of the courts with the speculative nature of the corporate-level tax can be traced to *Estate of Cruik-*

The parties had agreed that the stock was to be valued in accordance with the value of the corporation's underlying assets.

shank vs. Commissioner, 9 T.C. 162 (1947), which was also cited by *Piper*. There, the decedent owned stock in a family corporation that was an investment holding company. The taxpayer and the government had stipulated as to the value of the underlying assets. In addition, the parties had agreed that the stock was to be valued in accordance with the value of the corporation's underlying assets. The only issue before the court was whether a discount from the stipulated value should be permitted for the cost of disposing of the corporation's assets (i.e., stamp taxes, corporate capital gains taxes and commissions). The court held that a discount was not available with respect to any of these disposition costs.

The court offered two alternative reasons for denying the discount. First, the court refused to assume that the assets would be removed in a taxable transaction from corporate solution. In the court's perception, a taxable disposition by the corporation of its assets was conjectural; therefore, the tax costs associated with such a disposition should be disregarded. Second, the court indicated that where the value of corporate stock is derived by examining the value of the underlying corporate assets, the focus should be on the price the corporate assets would bring in the marketplace. So viewed, the value of the underlying assets should be determined without regard to any income-tax liability that would be incurred by the corporation on the sale.

As to the court's "conjecture" rationale, it should be noted that the corporation could have completely avoided tax liability on the appreciation inherent in its assets. At that time, a corporation was permitted to distribute its assets in liquidation without paying a corporate tax. The corporation, of course, would have been subject to income tax had it sold its assets. But there was apparently nothing in the record before the court to suggest that a sale was anticipated. And the court could not overlook the possibility that a liquidation might occur, which would eliminate all corporate tax on the appreciation in the corporation's assets, though the court did not explicitly mention such a possibility. Thus, the court would obviously have been uncomfortable in granting a discount for corporate tax that might never be paid.

It would seem that, given the court's alternative rationale, it would not allow a discount for taxes, even if evidence of an anticipated sale or corporate-tax triggering event were present. The price that the corporation could obtain in the marketplace for its assets would not be affected by the amount of corporate income tax that the sale or other tax-triggering event would generate. Thus, the *Cruikshank* court would presumably still deny a discount for taxes even where it was certain that a corporate tax would ultimately be paid.

Although the *Piper* court cited *Cruikshank*, its discussion of the issue was framed in terms of *Cruikshank's* "conjecture" rationale — not even a reference was made to *Cruikshank's* alternative rationale. This might be read as an implicit disavowal of *Cruikshank's* alternative rationale. But this reading is belied by *Piper's* citation to *Estate of Robinson*, 69 T.C. 222 (1977).

In *Robinson*, the decedent owned an installment obligation that was received in a sale for which the decedent elected to report gain on the installment basis. The estate sought a discount for the income taxes that would be paid by the beneficiaries (or the estate) on the gain deferred by the decedent. The court rejected the discount on the ground that estate-tax value should be determined by the price that a hypothetical buyer would be willing to pay for the installment obligation. The income tax generated by the sale of the obligation would have no bearing upon the price that such a buyer would offer.

The *Robinson* court's analysis is the same as the alternative rationale in *Cruikshank*. It would seem, therefore, that as reflected by this citation to *Robinson*, the *Piper* court probably intended to rely on both rationales articulated in *Cruikshank*. Thus, it is possible that the Tax Court would continue to deny a discount for taxes even if it were to conclude that the repeal of *General Utilities* negated the conjectural character of the corporate-level tax.

Character of the Tax

In the author's view, the tax-discount issue should turn solely on an analysis of the conjectural character of the tax, and the *Cruikshank* alternative rationale should be limited to the *Robinson*-type template. As the court in *Robinson* held, a discount should not be permitted for the income tax that would be generated by a sale of the asset subject to valuation. To permit such a discount would deviate from the valuation norm, namely, the price that a hypothetical buyer would be willing to pay; such a buyer would make a judgment as to the price he would offer without regard to the income tax payable by the seller. But to extend this reasoning, as the *Piper* court apparently did by its citation to *Robinson*, into a context where the valuation of corporate stock is determined by calculating the net asset value of underlying assets is inappropriate. The issue in this context is not the price that the underlying assets would bring in the marketplace, but rather the price the marketplace would set for the corporate stock.

To be sure, the repeal of *General Utilities* has affected the conjectural aspect of the corporate-level tax. Under the Act, it is certain that a corporation with appreciated assets will pay tax on the appreciation should the corporation sell the assets or liquidate — whereas, under the pre-Act law, no such certainty existed because of the possibility of a tax-free liquidation. But since it is possible that the corporation will neither sell its assets nor liquidate, it is not certain that the corporation will eventually pay the corporate tax. Although this uncertainty leaves the tax issue somewhat conjectural, the issue is substantially less conjectural than it was under *General Utilities*.

The question is whether, under the Act, the tax issue remains too conjectural to permit a discount. Even though under the Act a corporate tax might never be paid on appreciation in corporate assets, the marketplace of hypothetical purchasers will surely want to know, and seek appropriate discount for, any negative tax consequence inherent in the corporate structure. Where the value of corporate stock is valued by reference to the corporation's underlying assets and liabilities and where, as the Act now requires, a tax is imposed when assets are removed from corporate solution (whether at sale or liquidation), the tax should be treated like any other contingent liability of the corporation.

Just as the purchaser of corporate stock would take into account a non-tax corporate liability in making a judgment about the net value of the underlying assets, so too he would take into account the corporate tax liability that would accrue at the point of sale or liquidation. And even if the purchaser did not contemplate a sale or liquidation, he would surely take into account in determining an appropriate price his concern about securing a fair-market value basis in the depreciable assets held by the acquired corporation; that is to say, he would seek a discount to compensate for the diminished depreciation deduction attributable to a basis in the underlying assets that is below fair market value. To reflect these realities of the marketplace, a discount should be permitted for the corporate-level tax despite any residual conjecture surrounding the issue.

Valuation on the basis of underlying asset value is predicated on the assumption of a hypothetical liquidation. It would seem inconsistent to hypothesize a liquidation for purposes of valuing the underlying assets, while ignoring the liquidation because it is hypothetical or conjectual as the focus shifts to the corporate tax liability that would be triggered by a liquidation.

Before completing an analysis of the conjecture issue, it must be observed that the Act does permit one method by which many corporations can still liquidate without incurring a corporate tax. Under new § 1374, a C corporation that converts over to an S corporation will be required to pay a corporate-level tax at the time of liquidation on "built-in gains" — essentially the appreciation accruing prior to the S corporation election. But this new tax on "built-in gains" is only applicable to asset dispositions made by the corporation for the 10-year period beginning on the date of its conversion to S status. Thus, a technique still exists by which a corporation that meets the requirement for an S election can liquidate or sell its assets without triggering a corporate-level tax: If a corporation converts over to an S corporation and then waits 10 years before disposing of its assets, no tax will be imposed on the corporation in connection with the liquidation or the sale of its assets.

Does this technique for avoiding the corporate tax make the discount inappropriate? A hypothetical purchaser might certainly take the availability of this technique into account as he considers the price he would be willing to pay for the stock. And in doing so, he would give thought to his plans for the corporation after acquisition. If, for example, he expected to maintain the corporation for a substantial period of time, he might not be concerned about the corporate-tax issue, recognizing that the issue could be avoided by making an S election and waiting 10 years before liquidating — though waiting 10 years for the basis step-up and concomitant depreciation deduction produced by a liquidation will result in foregone tax savings. On the other hand, if such a purchaser contemplated a possible sale of the corporate assets or a liquidation within the near term, the tax issue would certainly loom larger.

Without question, the 10-year waiting period complicates the conjecture issue. But it is certain that a purchaser would prefer to acquire the underlying assets than the stock if the stock carried with it two unpleasant alternatives: 1) a corporate tax in the event of liquidation or; 2) a 10-year waiting period before liquidating. It would seem that, despite the availability of an S election, a well-informed purchaser would demand an appropriate discount if he purchased the stock and thereby agreed to endure one

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of these unpleasant alternatives. In addition, since the field of hypothetical purchasers eligible to use the S-election technique is not without limits,[14] the demand for such a discount would be difficult for a hypothetical seller to resist. Thus, though the amount of the discount may be difficult to calculate, it is nevertheless appropriate, given these observations about the marketplace of hypothetical purchasers.

Thus far, the primary focus of this article has been on the valuation of holding- or investment-type companies. Before concluding, a few words are in order about operating companies.

Operating Companies

Whereas a holding- or investment-type company is valued by emphasizing the net value of the corporation's underlying assets, an operating company that sells goods or services is valued, according to Revs. Rul. 59-60, by emphasizing earnings. The computation of earnings for this purpose is made on an after-tax basis.[15] Consequently, a discount for the corporate-tax issue should be implicitly factored into the valuation.

In other words, an operating company with plant and equipment having a low basis in relation to fair market value would be entitled to less depreciation for tax purposes than would a similar company with a basis in its assets approximating fair market value. Because of the disparity in the depreciation deduction available to these companies for tax purposes, the low-basis company would generate a greater tax and therefore less after-tax earnings. As these earnings are capitalized in order to arrive at value, the low-basis company, having a lower after-tax earnings, will be determined to have a lower value. Thus, the capitalization-of-earnings approach, which is the principal determinant for an operating company, implicitly discounts for the corporate-tax issue.

Conclusion

Without question, purchasers will be concerned about the tax posture of corporations they seek to acquire. In examining the corporation they contemplate acquiring, purchasers will surely take into account the repeal of *General Utilities*. And since valuation for estate-tax purposes is a function of the marketplace of hypothetical purchasers and sellers, it is appropriate to reflect in the tax valuation a discount for the corporate-level tax that purchasers will require. □

FOOTNOTES

1. See Sec. 334(a) of the Code; when the purchaser is a corp., an election under § 338 would be available.

2. See Sec. 336 of the Code and § 337 in the case of a §338 election, as it existed prior to the Act. But even under pre-Act law, there were instances in which a liquidating corporation was required to recognize gain. For example, a liquidating corporation was required to recognize depreciation recapture income. (Sections 1245 and 1250 of the pre-Act code.) In addition, see *Hillsboro National Bank vs. Commissioner*, 460 U.S. 370 (1983), 370 (1983), where the court held that the tax-benefit rule requires income recognition when events occur that are fundamentally inconsistent with an earlier deduction. Although the tax-benefit and recapture concepts resulted in some liquidations being taxable in part under the pre-Act law, no case could be found discussing the implication in the estate-tax context.

3. See Sec. 337, as it existed prior to the Act; see, also note 2.

4. Section 631 of the Tax Reform Act of 1986.

5. Id.

6. For a discussion of the income-tax aspects of the repeal of *General Utilities*, see Bonovitz, *Impact of the TRA Repeal of General Utilities*, 65 JTAX 388 (Dec. 1986).

7. It may not be necessary to actually liquidate the acquired corporation. An election under § 338 of the code creates the effect of a liquidation for tax purposes, though the acquired corporation remains intact.

8. Of course, no depreciation deduction would be available with respect to the land.

9. See Section 336 of the code.

10. Fortune, Dec. 8, 1986.

11. See, e.g., Revs. Rul. 59-60, 59-1 C.B. 237.

12. In Lowndes and Kramer, *Federal Estate and Gift Tax* (1962), at p. 526, the authors state that there is ". . . a question as to whether the actual or fictional costs of liquidation, such as selling costs and taxes, should be deducted from assets value." But see *Weber vs. Rasquin*, 101 F.2d 62 (2d Cir. 1939), and *Forbes vs. Hassett*, 38 F. Supp 62 (D. Mass. 1941), revd. on other issues 124 F.2d 925 (1st Cir. 1942). In the former case, the Second Circuit held that the expenses of liquidation should be taken into account; but it must be noted that a liquidation of the corporation at issue was in fact contemplated, though the court observed that the decision to liquidate might be reversed. In the latter case, the court, noting that no liquidation was anticipated, held that a discount was appropriate for the expenses associated with a liquidation.

13. See, however, note 12.

14. Certain purchasers will be unable to take advantage of S treatment. Section 1361 (b)(1) of the Code provides that in order to elect to be an S corporation, a corporation must satisfy each of the following conditions: 1. It must be a domestic corporation that isn't an ineligible corporation; 2. It must have more than 35 shareholders; 3. Each shareholder must be an individual who isn't a nonresident alien; and 4. It can have only one class of stock.

15. See Lowndes and Kramer, note 12, at p. 523.