Unallocated Premium In Corporate Acquisitions Under The American Law Institute Subchapter C Proposals

This paper was first written in 1979 while I was still in law school, for a seminar on Corporate Tax Policy taught by Professor Bernard Wolfman. At the time, he was one of the consultants for a project by the American Law Institute for the reform of the corporate tax law. Naturally, he was keen to get his students to write about those proposals; and since most of us had no ideas for a paper topic, we were happy to follow his suggestions.

I ended up drawing the topic of "unallocated premium." This ungainly term is used in the ALI Proposals to refer to two different things, depending on the context. In the context of an asset or other "cost basis" acquisition, it essentially means goodwill: the excess of the purchase price over the sum of the values of the identifiable assets acquired. In the context of a stock of other "carryover basis" acquisition, it means the excess of the purchase price over the tax basis of those assets. The use of this term is at times confusing, but it also facilitated the development of common themes for cost-basis and carryover-basis acquisitions, as was done in this paper.

At the time, the ALI Proposals seemed like pie in the sky, but many of the corporate tax reforms of the 1980s were inspired by these proposals, most notably the repeal of the *General Utilities* doctrine, the creation of the Section 338 election to treat a stock purchase as an asset purchase, and the Section 382 limitations on the use of loss carryforwards. And in a small way, this paper may have influenced those developments.

Professor Wolfman encouraged me to publish the paper, so I submitted it to *The Tax Lawyer*. At that time, the editor-in-chief was

James Lewis, a giant of the tax bar at Paul Weiss who had long been a champion of *General Utilities* repeal and was a consultant for the ALI as well. He assigned one of his associates at Paul Weiss, David Patterson, to edit the paper, and I remain grateful for his hard work in turning what was essentially a piece of student writing into something more respectable professionally.

The paper appeared in the Winter 1981 issue of *The Tax Lawyer*.[1] Shortly afterwards I heard from one of my classmates, André LeDuc, now a partner at Skadden Arps but then on the staff of the Senate Finance Committee, which was developing some proposals on corporate tax reform, including *General Utilities* repeal. The Finance Committee's 1983 proposals for *General Utilities* repeal included an exception for goodwill, consistent with the ALI Proposals. Their report, however, noted the existence of arguments against such an exception, citing my paper.[2] A couple of years later, when the House Committee on Ways and Means was developing tax reform legislation, they included *General Utilities* repeal but dropped the exception for goodwill.[3] And that was the form in which *General Utilities* repeal was included as part of the Tax Reform Act of 1986.[4]

What I failed to realize as a law student in the 1970s was that goodwill was where the money was, particularly in the overheated stock markets of the next two decades. The need to protect this new addition to the corporate tax base led to a series of further restrictions, starting with changes to block "son of mirror" transactions,[5] and culminating in the restrictions on "reverse Morris

1 34 TAX LAW. 341 (1981).

2 STAFF OF THE SENATE FINANCE COMMITTEE, THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS, S Prt. 98-95, at 97, nn. 9–10. *See also* STAFF OF THE SENATE FINANCE COMMITTEE, THE SUBCHAPTER C REVISION ACT OF 1985, S Prt. 99-47, at 67 (keeping the exception for goodwill).

3 *See* H.R. REP. NO. 99-426, at 282–88 (1985).

4 Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269–75.

5 *See* Notice 87-14, 1987-1 C.B. 445.

Trust" transactions.[6] I began to think that tax policymakers had taken this idea too far, and thought about writing another paper saying just that. As it turned out, however, someone else wrote that paper instead, saving me the trouble.[7] And fittingly, the author, Ruth Mason,[8] was another student in that same Corporate Tax Policy seminar, more than 20 years after me.

6 *See* I.R.C. § 355(e).

7 Ruth Mason, *Spinning* Morris Trust: *Interpreting 355(e) According to its Purpose?,* 94 TAX NOTES 1685 (Mar. 25, 2002)

8 She is now at the University of Virginia School of Law.

Contents

I. INTRODUCTION

The Federal Income Tax Project of the American Law Institute recently drafted a set of proposals[9] for a sweeping reform of the tax law of corporate acquisitions. Under existing law, the tax consequences of a corporate acquisition depend largely on its form: whether stock or assets are acquired, and whether the transaction is characterized as a "reorganization"[10] or as a "sale." The ALI Proposals eliminate these distinctions, and propose that the tax consequences of an acquisition depend on whether the parties explicitly elect to treat the transaction as a "carryover-basis transfer" or as a "cost-basis transfer." Several other major improvements on existing law are also proposed.

This article briefly summarizes the ALI Proposals, and comments on them by analyzing a central concept that they employ: unallocated premium, defined as the excess of the cost of an acquired business over the tax basis of its assets in the hands of the purchaser. Unallocated premium occurs both in carryover-basis transfers and in cost-basis transfers under the ALI Proposals, although its significance is different in the two contexts. Both are considered below.[11]

9 ALI FED. INCOME TAX PROJECT (Tent. Draft No. 1, 1977) (subchapter C, corporate acquisitions except for special limitations on loss carryovers) [hereinafter cited as ALI Proposals].

10 *See* I.R.C. § 368 (providing statutory definition of reorganization).

11 For a recent and more comprehensive review of the ALI Proposals, see Renato H. Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743 (1980).

II. BACKGROUND: THE ALI PROPOSALS

A. *The Carryover versus Cost-Basis Election*

Unlike similar efforts in the past,[12] which have been criticized for their conservatism and complexity,[13] the ALI Proposals represent a radical reform and drastic simplification of corporate tax law. Rather than trying, for example, to establish a more rational definition of a reorganization,[14] the ALI Proposals abandon the concept altogether. They recognize that under existing law, the parties to an acquisition generally can, by controlling the form of the transaction, determine whether gain on appreciated corporate assets will be recognized, and their bases stepped up accordingly (as in a sale of assets), or whether the gain will be deferred, and the bases of the corporate assets carried over (as in a stock sale or reorganization). The first objective of the ALI Proposals is to make this effectively elective choice an explicitly elective one, by permitting the parties to decide to treat the transaction as a carryover-basis transfer or a cost-basis transfer, regardless of its form.[15] Tax planning for corporate acquisitions is thus made simpler and more certain. The explicit election poses no greater threat to the revenue than the effective election that already exists; on the contrary, since the parties must elect consistently, the potential for their

12 *See*, *e.g.*, ALI FED. INCOME, ESTATE AND GIFT TAX PROJECT, *Income Tax Problems of Corporations and Shareholders* (1958); ALI FED. INCOME TAX STAT. 1–85, 193–352 (Feb. 1954 Draft).

13 *See* James B. Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM—COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1643, 86th Cong., 1st Sess. (1959).

14 For a valiant attempt to preserve the reorganization concept by clarifying its definition, *see* Walter J. Blum, *Corporate Acquisitions Under the Income Tax: Another Approach*, 50 TAXES 85 (1972).

15 ALI Proposal IIA, at 49–50.

"whipsawing" the government by taking inconsistent views of the transaction is removed.

The treatment of an elective carryover-basis transfer under the ALI Proposals closely resembles the treatment under present law of a simple purchase of corporate stock. Conversely, the treatment of an elective cost-basis transfer under the ALI Proposals parallels the current treatment of a purchase of assets. These two alternative treatments may be summarized as follows.

In a carryover-basis transfer, no tax is paid by the corporation whose business is being transferred, and the basis of the corporate assets remains unchanged. Suppose, for example, that a target corporation *X* has inventory worth $200 with a basis of $150, goodwill worth $100 with a basis of zero, and other assets worth $700 with a basis of $500. Under existing law, if another corporation *P* acquires the stock of *X*, *X* will not realize any gain; the basis of its assets will remain unchanged; and the former owners of the business will recognize a capital gain on their investment at the shareholder level. This result is the same under the ALI Proposals.[16] The innovation of the ALI Proposals is to permit the same tax consequences where the acquirer purchases the target's assets, provided that the target distributes any cash that it receives. All that the ALI Proposals require in this case is that substantially all of the assets of the selling corporation be acquired, and that the parties jointly and affirmatively elect carryover-basis treatment.[17]

16 In the absence of an affirmative election, the parties to a stock purchase are presumed to have elected carryover-basis treatment and need not affirmatively so elect. *Id.*

17 ALI Proposal IIIA, at 82–83. The sale of less than substantially all of a corporation's assets may in some cases also qualify for carryover-basis treatment, according to a tentative ALI proposal. *See* ALI Proposal IIIC, at 101–102. The aim is to preserve the electivity that currently exists with respect to such a partial sale, in that existing law often allows carryover-basis treatment if the assets to be sold are held in subsidiary form. The tentative proposal requires, however, that such a carryover-basis sale of less than substantially all the seller's assets not be part of a larger transaction in which cost-basis treatment is sought for other as-

In a cost-basis transfer, a corporate tax is paid by the corporation whose business is being transferred, and the basis of the corporate assets steps up to the amount paid for them. Thus, under existing law, if *X*, our target corporation in the example above, were to sell its assets directly to *P* for $1,000, it would recognize the appropriate kind of gain on each asset to the extent of the purchase price allocated thereto, and *P* would have corresponding stepped-up bases in the assets. Again, these consequences of an asset sale are preserved under the ALI Proposals,[18] but the same treatment is also made available when the acquirer purchases the target's stock. If the parties to a stock sale affirmatively elect cost-basis treatment, the target corporation will be treated as having sold its assets; it will be taxed accordingly and the acquired assets will take stepped-up bases.[19]

Under existing law, a carryover of basis and a deferral of corporate tax may also be achieved by causing the transaction to qualify as a tax-free reorganization.[20] A complete review of the treatment under the ALI Proposals of reorganization-type transactions is beyond the scope of this article.[21] In brief, the ALI Proposals replace the entire labyrinthine structure of the current reorganization rules with the explicit carryover versus cost-basis election, subject only to the "substantially all" requirement,[22] and dispense with the nonstatutory "business purpose"[23] and "continuity of interest" doctrines.[24]

sets. It also requires that if consideration other than the purchaser's stock is received, the sale be of at least a "major portion" of the seller's assets. *Id.*

18 In the absence of an affirmative election, the parties to an assets sale are presumed to have elected cost-basis treatment. ALI Proposal IIA, at 49–50.

19 ALI Proposal IVA, at 122–23.

20 I.R.C. §§ 354, 361, 368.

21 *See* Beghe, *supra* note 11, at 756–62.

22 *See supra* note 17.

23 *See* Treas. Reg. §§ 1.368-1, 1.355-2(c); *see, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935).

24 *See* Treas. Reg. §§ 1.368-1(b), 1.355-2(c). *See also* Peter L. Faber, *Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?* 34 TAX LAW. 239

Taxation of individual shareholders under the ALI Proposals would be independent of the election by the corporate parties. Instead, only the "boot" received by each shareholder would be taxed, as under the existing reorganization rules.[25] One key difference is that the presence of boot would cause recognition of gain only to the extent of the boot, whereas under existing law it may cause the taxation of all gain.[26] If, in our example, the stock of *X* were acquired in exchange for stock of *P* worth $400, plus $600 in cash, the shareholders of *X* would recognize gain only to the extent that they received cash. If *X* sold its assets for the same consideration, the shareholders would recognize gain only to the extent that the cash was distributed to them.

B. *Repeal of the General Utilities Doctrine*

A second objective of the ALI Proposals, in addition to making elective the payment or deferral of the corporate level tax at the time of transfer, is to ensure that, whether deferred or not, the tax is at some point paid. Under existing law, it often is not. The various ways in which it may be escaped trace their origins to the *General Utilities* case,[27] which gave its name to the doctrine that a corporation realizes no gain upon the distribution of appreciated assets to its shareholders. This doctrine has now been codified,[28] and extended to cover distribu-

(1980); Bernard Wolfman, "*Continuity of Interest" and the American Law Institute Study*, 57 TAXES 840 (1979).

25 ALI Proposal VA, at 172–73; I.R.C. § 356.

26 *Cf.* Turnbow v. Commissioner, 368 U.S. 337 (1961) (construing analogous provisions in the 1939 Code). The ALI rule thus eliminates the anomaly, possible under existing law, that one shareholder who receives only stock may be taxed because other shareholders have received boot. *See* Kass v. Comm'r, 60 T.C. 218 (1977), *aff'd by* 3d Cir. (Jan. 18, 1979) (unpublished opinion).

27 General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

28 I.R.C. § 311(a).

tions in liquidation,[29] and sales in anticipation of liquidation.[30] Combined with the allowance of a stepped-up basis in the hands of the shareholder,[31] these provisions effectively grant an exemption from the corporate tax upon a carefully planned acquisition. In the example above, *X* could, under existing law, distribute its appreciated assets to its individual shareholders without recognizing gain,[32] and the shareholders could then sell the assets to *P* for $1,000; or *X* could sell its assets directly to *P* for $1,000 and promptly liquidate;[33] or the *X* shareholders could sell their shares to *P*, which could then promptly liquidate *X*. In each case, the *X* shareholders would pay individual income taxes on the gain they had made in their investment, but *X*'s unrealized gain on the appreciated assets would escape a corporate level tax.[34]

[29] I.R.C. § 336.

[30] I.R.C. § 337.

[31] I.R.C. §§ 301(d)(1), 334(a). *See also* Kimbell-Diamond Milling Co. v. Comm'r, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1950), *codified at* I.R.C. § 334(b)(2). *See also* American Potash & Chemical Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968) *(Kimbell-Diamond* rule extends beyond its statutory codification).

[32] Certain restrictions on this ability to escape the corporate tax are contained in §§ 311(b) and 336(b) (LIFO inventory), 311(c) (liabilities in excess of basis), and 311(d) (certain redemptions). *See also* I.R.C. §§ 47(a)(1) (investment credit recapture); 341(f)(2) (gain on the disposition of certain assets of collapsible corporations); 453(d) (installment obligations); 1245 and 1250 (depreciation recapture). For a review of the non-statutory grounds on which the Service may assert that gain is recognized by a distributing corporation, *see* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 7.21 and 11.63 (4th ed. 1979). As the ALI Proposals note, the root problem of existing law may be the *General Utilities* doctrine itself, but a derivative problem is the complexity of the exceptions to the doctrine. ALI Proposals, at 116.

[33] Section 337 is also subject to a number of restrictions. I.R.C. §§ 337(b), (c), (f), 897(d)(2). For a comprehensive review, see BITTKER & EUSTICE, *supra* note 32, ¶¶ 11.64, 11.65, 11.66.

[34] For the sake of simplicity, the focus here is purely on whether *some* tax is paid at each of the corporate and shareholder levels. The taxes at each level may of course be at ordinary or capital gains rates under different circumstances. Indeed, the shareholder tax may be at ordinary rates precisely because the

The ALI Proposals seek to protect the integrity of the corporate tax by a general repeal of the *General Utilities* doctrine in all its manifestations. Under the ALI Proposals, *X* in our example would not be permitted either to distribute its appreciated assets for sale to *P*, or to sell them directly to *P* in anticipation of *X*'s liquidation, without recognizing gain. If *X*'s shares were sold, *P* could only get a basis step-up by a cost-basis election, but if such an election were made, *X* would recognize gain on the appreciated assets as if it had sold them. In short, the basis of corporate assets can be stepped up under the ALI Proposals only at the price of a corresponding tax on the gain to the transferor corporation.

C. *The Elimination of "Cascading"*

A third objective of the Proposals—in addition to allowing an elective deferral of the corporate tax, and at the same time ensuring that it is only deferred, and not escaped—is ensuring that a corporate tax is not paid more than once.[35] Multiple corporate level taxation, so-called "cascading," can occur whenever there is more than one corporation between the individual shareholders and the underlying assets, and one such corporation sells its shares in another.

A simple instance of cascading can be shown by assuming that *X* in our example is itself owned by *Y*, which, having capitalized *X* with exactly the amount of money necessary to purchase its assets, has the same basis in the shares of *X* that *X* has in its assets: $650. The *X* shares, like the *X* assets, are worth $1,000. If *X* recognizes the inherent gain by selling its assets, that gain will be taxed to it, and if *Y* then

corporate level tax has been avoided, if the avoidance should catch the attention of "that erratic policeman, the collapsible corporation provision [section 341]." Lewis, *supra* note 13, at 1645. The payment of that penalty does not satisfy the concerns of this article, however, nor those of the ALI Proposals, which seek to make section 341 unnecessary. ALI Proposals, at 18.

[35] ALI Proposals, at 11.

sells the *X* shares, *Y* will be taxed again on the same gain (less the tax *X* has paid). The individual shareholders of *Y* will again be taxed on the same gain (less the taxes *X* and *Y* have paid) if they should then sell their shares.

Taxing a shareholder on gain that has already been taxed to the corporation is proper when the shareholder is an individual, because the result is one corporate income tax and one individual income tax, the normal tax price for doing business in corporate form. It is not proper where the shareholder is a corporation, because the result is multiple corporate level taxes, and excessive tax price for doing business through subsidiaries rather than divisions.[36]

The prudent corporate parent avoids this multiple tax under existing law by distributing appreciated subsidiary property, either in a tax-free dividend[37] or a tax-free liquidation,[38] before the property is sold.[39]

36 This form of cascading is only one of many possible forms. If, for example, *P* were to buy the *X* stock from *Y* for cash, *Y* would pay tax on its gain, and *P* would get a stepped-up basis in the *X* stock. If, however, *X* were liquidated several years later, the cost basis in its stock would disappear, and the carryover basis would take its place under section 334(b)(1), leaving *P* potentially taxable on gain already taxed to *Y*. Such cascading can happen even without liquidation: when *Y* sells the *X* stock, *Y* is taxed on the unrealized gain in *X*'s assets, yet *X* itself will be paying a second corporate tax when the gain is realized.

The dividends-received deduction under section 243 wreaks havoc with these cascading possibilities, and can even make it possible to turn a double tax on gain into a gratuitous loss deduction, simply by making ongoing distributions from the subsidiary before the sale large enough to bring its value below the cost basis of its stock. The consolidated return provisions narrow this loophole by adjusting stock basis upward for the earnings and profits of a subsidiary, and downward for the dividends it pays. *See* Treas. Reg. § 1.1502-32. Even under the consolidated-return rules, however, cascading of corporate taxes can occur when a corporate parent sells its subsidiary shares, and the subsidiary later recognizes gain reflected in the sale price.

The various possible forms of "slippage" that may occur under existing law between corporate tax and basis adjustments are further described in Ditkoff, *Intercorporate Dividends and Legitimate Tax Avoidance*, 4 J. CORP. TAX'N 5 (1977).

37 I.R.C. § 243(a)(3).

38 I.R.C. § 332(a).

The ALI Proposals adopt a more direct solution, which is to provide that in all circumstances a corporate parent's basis in its subsidiary shares will be equal to the subsidiary's net aggregate basis in its assets.[40] In our example, when *X* sells its assets and recognizes $350 of gain, *Y*'s basis in the *X* shares is correspondingly stepped up to $1,000 (less the tax *X* paid on the sale), so that the $350 gain would not be again taxed to *Y* if it were then to sell the *X* shares.

D. *Unallocated Premium Under the ALI Proposals*

The proper treatment of unallocated premium is central to the scheme thus developed by the ALI Proposals and critical to the achievement of their objectives. The pervasive concern of the Proposals is to ensure that the corporate tax, although it may be deferred, is neither lost nor compounded as assets pass through successive corporate owners. Since unallocated premium represents the excess of the cost of a business over the tax basis allocable to the purchased assets, it has a major impact on the purchaser's future corporate tax liability.

The precise impact of unallocated premium is in fact quite different in the two contexts of carryover and cost-basis transfers. The essence of a carryover-basis transfer is that the corporate tax has been deferred. The unallocated premium is the measure of the deferral; it

[39] Careful planning may not be enough. In Comm'r v. Waterman Steamship Corp., 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971), ICC regulations required a sale by a corporate parent of its shares in a subsidiary which owned a substantially appreciated steamship. The parent sought to reduce the gain on the sale by causing the subsidiary to pay its note as a dividend. *Id.* at 1189. The note was paid after the sale with funds supplied by the purchaser, the intended effect being to turn the capital gain into a dividend eligible for the dividends received deduction. The Fifth Circuit, however, treated the dividend as part of the sales proceeds, and taxed the parent accordingly. *Id.* at 1196. *But see* TSN Liquidating Corp. v. United States, 642 F.2d 1328 (5th Cir. 1980) (dividends-received deduction allowed for pre-sale distribution of subsidiary assets not wanted by purchaser).

[40] ALI Proposal IIB, at 70–71.

represents the unrealized appreciation in corporate assets that is untaxed at the time of the transfer, but through the carryover basis is ultimately taxable to the purchaser. In the example used above, the unallocated premium in a carryover-basis transfer is $350, the difference between the cost of the acquired business ($1,000) and the tax basis of its inventory and other assets ($150 plus $500).

The important question that immediately arises is how this unallocated premium, representing the gain on which the corporate tax has been deferred, should be treated by the purchaser in future dealings with the assets. This question, in turn, leads quickly to another, which is whether our premise is correct: whether the tax on the full amount *has* in fact been deferred, if, as may well be the case, the transferor has paid a corporate tax on that part of the cash sale proceeds that it has retained and not distributed to its shareholders. These questions are addressed in Part III of this article.

In a cost-basis transfer, a corporate tax on existing appreciation is levied at the time of the transfer. Typically, however, there will still be an amount of unallocated premium. This is because a portion of the value of a business will not be attributable to its identifiable assets, but instead will represent goodwill or going concern value. Indeed, in the cost-basis context unallocated premium is defined as the amount of this goodwill or going concern value.[41] In our example, $250 of the $350 of total appreciation in the values of *X*'s assets represents an increase in the value of its identifiable assets ($50 of inventory plus $200 of other assets). The $100 remainder represents the value of *X*'s goodwill. This latter amount is the unallocated premium when cost-basis treatment is elected.

If, in a cost-basis transfer, this amount of unallocated premium enters the purchaser's basis only as the nonamortizable cost of goodwill, the question arises whether the corresponding gain *should* be

41 ALI Proposal IVB at 130–31.

subject to corporate tax at the time of transfer. This and several related questions are addressed in Part IV of this article.

The special rules contained in the ALI Proposals for the treatment of unallocated premium in both the carryover and cost-basis contexts are the points of departure for the discussion below. The manner in which the Proposals treat unallocated premium merits close scrutiny for two reasons. First, the Proposals fail to resolve completely the troubling issues raised. Second, and more important, an analysis of the technical treatment of unallocated premium can be used to illustrate and appraise critically the basic attitudes toward the corporate income tax that underlie the entire body of the Proposals.

III. Carryover-Basis Transfers

A. *The Resale Problem*

As has been noted, when a corporate purchaser pays more for business assets than their net aggregate basis in the hands of the seller, and carryover-basis treatment is elected, the purchaser takes over the potential liability for corporate tax on the difference between the two amounts, that difference being the amount of unallocated premium. The purchaser will typically recognize that gain in the normal course of business through a combination of individual asset sales and the lack of a higher depreciation base. The corporate tax that was deferred at the time of the transfer is paid by the purchaser rather than the seller, as the Proposals contemplate that it should be. The parties have presumably understood this, and adjusted the purchase price accordingly. The same is true if the purchaser resells the entire business in a cost-basis transfer.

Let us assume, however, that the purchaser promptly resells the entire business[42] in another carryover-basis transfer, so that the potential liability on the gain passes to a new owner. Is there any reason for the purchaser/reseller to pay a tax? In our example, if *P* immediately resells the business to *Q* for $1,000 in cash, exactly what *P* paid for it, *P* has earned no economic gain. Yet *P* is liable, unless it distributes the entire $1,000 to its shareholders, for a corporate tax on the unallocated premium of $350.[43] The ALI Proposals perceive a problem here. They note that the carryover basis "is just a way of enabling *P* to take over *X*'s potential tax liabilities so that they would not have to be met in connection with the acquisition transaction itself."[44] And they continue:

42 Or, under certain circumstances, a "major part" thereof. *See supra* note 17.

43 *See infra* notes 52–62 and accompanying text.

44 ALI Proposals, at 92.

> On a subsequent carryover-basis resale, those responsibilities will be taken over by the new transferee, and there is arguably no need to tax the disposing corporation on anything more than its actual gain, adjusted for profits or losses realized by the business in question during the period of ownership.[45]

The reporter and team of consultants who developed the ALI Proposals apparently reached no consensus as to the best solution to the problem that they perceived. The text of the relevant Proposal itself simply states that a transferor's basis for purposes of computing gain in a carryover-basis transfer shall be "appropriately adjusted for any unallocated purchase premium or discount."[46] The comments on this Proposal offer four alternative versions of an "appropriate" adjustment.[47]

The first alternative is to give stock or assets acquired in a carryover-basis transaction a dual basis. One basis would be a carryover basis, which would be used for calculating depreciation deductions, gains on sales of inventory, and other purposes relating to the business. The other basis would be a cost basis, which would be used for calculating gain on a resale of the business in another carryover-basis transaction. This cost basis would be calculated as net aggregate asset basis plus unallocated purchase premium. Thus, the basis to *P* in our example would, in the event of a resale, be $650 (net aggregate asset basis) plus $350 (unallocated premium), or $1,000. The result would be that no tax would be imposed on an immediate resale at cost, the reseller having simply broken even.

The second alternative offered by the Proposals is to "just ignore [the problem], as in the case of a reorganization acquisition under existing law."

45 *Id.* at 92–93.

46 *Id.* at 93.

47 *Id.*

The third alternative offered is something of a compromise. The full unallocated premium would be added to basis in the event of a rapid resale. If the resale occurred later, however, after gain had been realized from the disposition of individual assets, the amount of premium added to basis would be reduced accordingly.

In our example, the net aggregate basis of *X*'s assets is $650. This basis carries over to *P*, whether *P* takes assets or stock; and because *P* purchased the business for $1,000, the unallocated premium is $350. Under the third alternative, this unallocated premium of $350 would be added to the asset basis of $650 to give a basis of $1,000 to apply against the amount realized in a carryover-basis resale. If before resale, however, some of the assets are sold at a gain of $50, the net aggregate asset basis will rise to $686, assuming a 28-percent tax on the gain. In a subsequent carryover-basis resale, the unallocated premium adjustment of $350 would be reduced by the $36 added to basis, so that the basis for resale purposes would be $686 plus $350 minus $36, or $1,000.[48]

These adjustments would give the transferor his cost basis, but no more. Without them, a reseller could get an unwarranted loss deduction. If the business in our example were resold for $1,000, after itself recognizing a $50 gain, and the full unallocated premium of $350 were added to the net aggregate asset basis of $686, a loss of $36 ($1,000 – ($350 + $686)) would be generated on the resale. This result could occur under the first alternative described above, a possibility that may be considered a defect in it.

The final alternative offered by the Proposals is another compromise: basis on resale would be net aggregate asset basis, or cost basis less distributions, whichever is greater. The cost basis would be de-

48 The Proposals also suggest that after these specific reductions, a fixed percentage of the remaining unallocated premium might be written off annually over a period of time. This timed phaseout of the adjustment for unallocated premium presumably reflects the fact that to the extent the unallocated premium is derived from goodwill rather than specific assets, the benefits of the goodwill probably will have been realized over that period. *Id.* at 94.

termined directly by reference to the purchase transaction, rather than indirectly as the sum of net aggregate basis at the time of resale plus some part of the original unallocated purchase premium. This approach spares the reseller having to calculate specific reductions of the unallocated purchase premium, but instead requires a record of distributions made from the acquired business. Since the assets of the business may be owned outright rather than through a subsidiary, such a rule may be difficult to administer.[49]

Furthermore, both the third and the fourth alternatives present tracing problems in that tax consequences hinge on what happens to the specific assets that were originally acquired. Gain on resale is only shielded to the extent that these specific assets are involved in the resale. These tracing problems increase with the frequency of such resales, and with the length of time over which the assets are held prior to a resale of the business.[50] The problems may be particularly severe if the purchaser, not anticipating an early resale, fails to keep adequate records of the dispositions of particular assets.

Of these alternatives, then, the first seems too generous, the second does nothing, and the third and fourth may be difficult to administer. Recognizing but not resolving these difficulties, the Proposals' draftsmen nonetheless conclude that they "do not undermine the proposal itself," since the Proposal in any event represents "an improvement over existing law,"[51] and since a transferor can in any event escape recognition of gain in a carryover-basis transfer by distributing any cash it receives. Despite these assurances, it is unsettling that the Proposals fail to resolve a problem that threatens to cause, if the correct adjustment is not made, a result that the Proposals specifi-

49 The comment acknowledges that the method "depends upon some separate accounting of profits from the acquired business, and would be easier to apply, therefore, in the case of a purchased subsidiary than a carryover-basis asset acquisition." *Id.*

50 A timed phaseout would partially alleviate this latter problem. *See supra* note 48.

51 ALI Proposals, at 94.

cally set out to prevent: the imposition of a corporate tax on two different corporations for the same gain.

The failure of the proposals adequately to resolve this problem may lie in their failure to perceive its true source. The problem only exists because a transferor in a carryover-basis transaction may in some circumstances pay a tax on the transfer even though basis carries over. This tax, which we will call the "retained boot tax," lies at the heart of the problem, and therefore warrants a closer inspection.

B. *The "Retained Boot Tax"*

As we have seen, the essence of a carryover-basis transfer is deferral of the corporate tax. The ALI Proposals espouse the view that if a carryover basis ensures that the transferee will ultimately be taxed on the unallocated premium, the transferor need not be taxed currently. As to the shareholders, the Proposals contemplate that they are to be taxed only to the extent of any cash or other boot received, the notion being that their receipt of boot signifies a complete termination of their investment, and should be a taxable event, whereas their receipt of the purchaser's stock should not be, since their investment continues.[52]

These two principles come into conflict if boot is received but retained inside the transferor corporation. To that extent there has been a complete termination of the investment by the original owners of the business, yet if they recognize no gain because they receive no boot, and if a deferral of the corporate tax is also allowed, no gain will have been recognized by anyone. Both the individual and corporate level taxes will have been deferred, despite the "cashing out."

The response of the ALI Proposals to this problem is to tax the transferor corporation on its gain, despite the carryover of basis, to

52 ALI Proposal VA, at 172–73.

the extent of any boot received and not distributed to shareholders.[53] This is the retained boot tax referred to above. Its stated rationale is that "it seems appropriate to impose a corporate tax just as a kind of price for arranging the transaction in a way that would otherwise avoid any current tax at either the corporate or shareholder level."[54] This retained boot tax parallels the treatment under existing law of boot retained by a transferor corporation after a reorganization.[55]

To illustrate the operation of the tax, let us assume that the assets of *X* in our example above are acquired for $1,000 in cash, which *X* then retains. In such a case *X* would pay a capital gains tax on the full $350 of unallocated premium. If the proceeds were partly cash and partly stock of the acquirer, the target corporation would still be taxed, but the gain recognized would be limited by the amount of the boot it retained.

The retained boot tax on a carryover-basis transferor has a striking feature: a corporate tax is paid without any corresponding step-up in corporate assets. The same gain that is taxed to the transferor will ultimately be taxed again to the acquirer, since the inventory and depreciable assets keep their former bases.

The double taxation effect is particularly vivid in the situation on which the ALI Proposals have focused, that is, where stock or assets acquired in a carryover-basis transaction are promptly resold in another carryover-basis transaction. If the assets acquired by *P* in our example were immediately resold to *Q* in another carryover-basis transfer for $1,000, *P* would recognize up to $350 in gain on any boot retained, even though *Q*, by virtue of the carryover-basis, would be

53 ALI Proposal IIIA, at 82–83. Another possibility would be to tax the shareholders on the retained boot. The Proposals do not entertain this possibility, perhaps because they adopt, as one of their basic premises, the retention of the existing segregation of corporate and shareholder level taxation, including the requirement that gain be realized at the shareholder level before it is taxed there. ALI Proposals, at 5–6.

54 *Id.* at 77.

55 I.R.C. § 361(b); ALI Proposals, at 85.

liable for tax on the same gain if it resold in a cost-basis transfer, or in a second carryover-basis transfer in which boot was retained. To push this example to a ludicrous extreme, imagine that the business changes hands in a carryover-basis transfer each day for an entire year. If each transferor were to receive and retain boot, paying the retained boot tax, the same $350 of unallocated premium would be taxed 365 times.

Although the ALI Proposals have focused on a particularly vivid example of this form of double corporate level taxation, the problem is in fact much broader. It arises whenever a corporate transferor pays tax in connection with a carryover-basis transfer. The first corporate tax on the appreciated assets of an acquired business occurs when the transferor receives and retains boot. The second corporate tax occurs when the transferee either sells the assets or derives income by using them in the business.[56]

If the problem is in this sense broader than that of prompt resales, in another sense it is narrower: it only arises, in the resale context or any other, when the retained boot tax is paid. If there were no such tax, or if it were avoided in each case by the distribution of any boot, the daily carryover-basis resales described above could go on indefinitely without any compounding of the corporate tax.

The real source of the problem is the use of the corporate income tax, apparently as a substitute for a tax on shareholders, without allowing a step-up in basis.[57] Because of the absence of a step-up in basis,

[56] The inability of the purchaser to recover its full cost through depreciation of the purchased assets is just as expensive to it, and just as much represents its payment of the deferred corporate tax, as its being deprived of a full cost basis for resale purposes.

[57] Existing law avoids the problem by stepping up the basis in the stock or assets whenever a corporate tax is paid in connection with their transfer. *See* I.R.C. § 362(b). The existing structure is less than perfect, however. If, for example, the stock of a subsidiary is acquired, rather than its assets, the recognition of gain by the seller will step up the basis in the acquired stock, but not the basis in the underlying assets. A second corporate tax will then be incurred when the subsidiary sells the assets or otherwise recognizes gain in the normal course of its business. The underlying problem is the possibility of divergence, under existing law, between the basis of a subsidiary's stock and the basis of its assets.

the tax on a corporate transferor in connection with a carryover-basis transfer is not a part of the overall income tax scheme, but is rather an arbitrary addition to it. It is particularly difficult to reconcile the retained boot tax with the dominant theme of the ALI Proposals that all corporate income should be taxed only once at the corporate level.[58]

Perhaps the tax could be viewed as an additional excise or penalty on the privilege of retaining boot in a carryover-basis transfer. Under this view, the retained boot tax is a needed safeguard to prevent a "rollover" of corporate assets in exchange for boot without recognition of gain at either the corporate or shareholder level, and possible multiple taxation is simply the price of having this safeguard. If this is the correct view, the retained boot tax is not really a corporate tax at all, and it is not a corporate tax that is compounded when basis carries over despite the payment of a retained boot tax. Under this view, therefore, there is no need for any of the alternative relief measures contained in the Proposals.[59]

58 The Proposals never affirmatively state that basis is not to be stepped up where a retained boot tax is paid. They appear to assume, however, that there is no such step-up. They make no reference, for example, to the obvious necessity of providing some rule for how a basis step-up is to be allocated among the transferred assets, and for how it is to be integrated with the affirmative election procedure. These points are touched on briefly in the text. *See infra* note 61 and accompanying text.

Perhaps more important, if there were a basis step-up, there would be no need for the various alternative solutions that the Proposals offer for the problem, as they perceive it, of the prompt carryover-basis resale. As shown above, a basis step-up would eliminate the danger of a compounded corporate tax upon successive resales. If the purchaser/reseller paid a corporate tax, because it retained boot, it would do so effectively at its own election; and it would be compensated for doing so by the higher purchase price that the purchaser would presumably pay for being relieved of a corresponding amount of corporate tax liability. This set of results is precisely what is contemplated by the allowance of an elective corporate tax deferral.

59 Viewed as a penalty, the retained boot tax is not very severe. It is entirely elective, since the transferor is free to distribute any boot it receives. Moreover, as a practical matter, at most only a part of the unallocated premium will be recognized as gain to the transferor in a carryover-basis transfer. If the retained boot

It is not at all clear, however, why the retained boot tax should be regarded as a penalty to be imposed in addition to the normal corporate tax. Although some safeguard may be necessary to prevent tax-free rollover, there is nothing inherently undesirable about retaining boot that justifies subjecting it to a special penalty. The Proposals themselves do not seem to so regard it, or they would not seek ways to mitigate the double tax, as described above. What justifies the retained boot tax is preventing deferral of both the corporate and individual tax upon a cash-out. The acceleration of the corporate tax would seem to be the appropriate remedy, but this remedy can be applied without a compounding of the tax. Tax-free rollover and cascading can both be prevented by imposing the retained boot tax, but giving the assets transferred a stepped-up basis to the extent that the corporate transferor recognizes gain.

What is proposed, then, is that carryover-basis treatment be in effect denied to the extent that acquisition proceeds constituting boot are retained by the corporate transferor. Instead, the retained boot tax that the ALI Proposals impose should be accompanied by a step-up in asset basis.[60]

equals or exceeds the potential gain—that is, the unallocated premium—there is no reason not to elect cost-basis treatment, which provides a stepped-up basis at the same current tax cost. An election of carryover-basis treatment, where the boot to be retained exceeds the potential gain, is thus an irrational choice, since it results in a complete elimination of any deferral, and yet no step-up in basis. The very possibility of this anomalous and costly result, which would befall only the unwary taxpayer, is itself a strong argument in favor of a step-up.

60 This solution, of course, goes against the grain of what a carryover-basis transfer is: a transfer in which basis carries over. To tax part of the gain, and allow the transferred assets to receive a stepped-up basis, is to determine that to this extent, carryover-basis treatment is inappropriate even if the parties elect it. But it *is* inappropriate, if one considers the reason for allowing carryover-basis assets transfers in the first place. The treatment of such transfers is intended to simulate, in a manner independent of the actual form of the transaction, the acquisition of the stock of a corporation. A stock acquisition puts the proceeds of the acquisition in the hands of the acquired corporation's shareholders. An asset acquisition produces the same result only if the transferor distributes the proceeds to its shareholders.

The partial cost-basis treatment that would result would be effectively elective, since boot can always be distributed. The parties to an acquisition would in practice negotiate the amount of boot that the transferor was to receive and retain, and the amount of the corresponding basis step-up. Their decision would be incorporated in the necessary affirmative election of carryover-basis treatment, again preventing the taking of inconsistent positions. Presumably, any partial step-up in basis would be prorated across all appreciated assets; the parties would not be permitted to elect carryover-basis treatment for some assets and cost-basis treatment for others.

To return to our example, if *X* sold its assets to P for $1,000 in cash, and the parties elected carryover-basis treatment, the election they filed might state that $100 was to be retained and not distributed by *X*. *X* would pay a tax on that amount of gain, and the basis of the transferred assets would be stepped up as follows: The inventory, with a basis to *X* of $150, a value of $200, and therefore 1/7 of the appreciation, would receive a new basis of $164. The other assets, with a basis of $500 to *X*, a value of $700, and therefore 4/7 of the appreciation, would receive a basis of $557. The goodwill, with a zero basis to *X*, a value of $100, and therefore 2/7 of the appreciation, would receive a new basis of $129. The overall result would be that the liability for corporate tax on the $350 of unrealized gain existing at the time of the transfer would be divided between *X* and *P*, and the purchase price adjusted accordingly by the parties.[61]

There remains the question whether the twin objectives of avoiding both tax-free rollover and cascading can be achieved when the retained acquisition proceeds are not boot but rather stock of the acquirer. Because of the continued investment by the transferor, the ALI Proposals impose no tax on the corporate transferor in such a

[61] The method of allocation suggested in text, according to the relative appreciation in appreciated assets, parallels the method that has been adopted in the analogous context of special adjustments to the bases of partnership assets under I.R.C. § 755. *See also* Treas. Reg. § 1.755-1(a)(1).

case even though the stock is retained, and there is thus no immediate threat of cascading.[62] The stock so received, however, takes a basis equal to that of the assets transferred. This substituted basis gives the stock a built-in tax liability for the same gain that has been shifted to the transferee through the carryover basis. The gain will be recognized if the transferor then sells the stock, raising anew the possibility of multiple taxation on the same gain.

Thus, if the assets of corporation *X* in our example, having a net aggregate asset basis of $650, were acquired for $1,000 of *P* stock in a carryover-basis transfer, the stock would have a basis of $650 in *X*'s hands, and the assets would have a basis of $650 in *P*'s hands. If *P* disposed of the assets, it would realize $350 of gain; if *X* then disposed of the stock, it would also realize $350 of gain, even though the gain derived from the same source had already been taxed to X.

One rather harsh way to avoid this problem would be to tax the transferor on all retained proceeds, both stock and boot, and to step up the asset bases accordingly, thus effectively mandating cost-basis treatment to the extent that any proceeds, stock or boot, are retained at the corporate level. This approach is harsh in that it denies the benefits of deferral under circumstances in which there is substantial continuity of investment. It is odd in any case to solve a problem of hardship to the taxpayer by restricting the taxpayer's options. Given these options, the careful seller can easily avoid this difficulty by distributing the stock that is not expected to be held within the transferor indefinitely. Also, cost-basis treatment can always be elected. There is no reason to foreclose the taxpayer from electing carryover-basis treatment with the possibility of multiple taxation later, if that is preferred to the certainty of a single tax now.

62 ALI Proposal IIIA, at 82–83.

C. *Summary*

The problem of resales, as perceived by the Proposals, appears instead to be a problem of the retained boot tax. The latter may well be necessary to prevent a complete disinvestment with no tax, but it also poses a threat of cascading. This cascading caused by the retained boot tax can be eliminated by stepping up the basis of the transferred assets, and the only remaining potential for cascading is caused by what might be called the deferred retained stock tax. This remnant of the cascading problem is perhaps an unavoidable feature of the ALI scheme and not one that in practice should create trouble for a reasonably careful corporate transferor.

IV. Cost-Basis Transfers

A. *The Problem of Goodwill*

Because the buyer in a carryover-basis transfer accepts liability for tax on the unrealized corporate gain at the time of transfer, any tax on that same gain paid by the transferor at the time of transfer threatens to compound the corporate tax. It was on this problem of potential "cascading" that attention was focused in Part III of this article. In the cost-basis context, the problem is the opposite: because the cost basis relieves the buyer of any future liability for tax on the corporate gain that is unrealized at the time of transfer, the transfer becomes the last opportunity to impose the corporate tax on that gain, and the central concern is with making sure that this opportunity does not pass with the tax being escaped entirely. As we have seen, the solution of the Proposals to the latter problem is to repeal the *General Utilities* doctrine and to adopt in its place the general rule that no asset may take a stepped-up basis in the hands of the transferee unless a corporate level tax has been paid by the transferor.[63]

Just as it is appropriate to modify the pure carryover-basis model in some circumstances, notably where boot is retained in the transferor corporation,[64] there may be circumstances in which the pure cost-basis model should also be modified. One such modification offered by the ALI Proposals[65] concerns unallocated premium, that is, that

63 *See supra* text accompanying notes 27–34.

64 *See supra* Part III.B (p. 20).

65 The ALI Proposals also include a shareholder credit for the capital gains taxes paid by liquidating corporations. *See* ALI Proposal IVD, at 138–39, which provides: "Any shareholder receiving a liquidating distribution from a corporation shall be allowed a credit against tax for his proportionate share of the corporation's liquidating capital gains tax." The effect is "to require that gain on a corporate liquidation be effectively taxed once, either at the corporation's capital

part of the purchase price in a cost-basis transfer that is not allocated to any of the purchased assets, but is attributable instead to the goodwill or going-concern value of the business.[66] The Proposals reason that such an amount will have no effect on the computation of the income of the business after the sale, and in this sense will be the equivalent of an amount of unallocated premium in a carryover-basis transfer. Because it would be "excessively harsh" to tax the seller on the amount of the premium in one case but not the other, when the buyer receives no benefit either way, the Proposals conclude that the seller in a cost-basis transfer should likewise be relieved of the tax.[67] The sole conditions are, first, that the amount of unallocated premium that is excluded from the seller's gain not be applied in any way by the buyer against the business's future income, and second, that the premium be distributed currently to the seller's shareholders.[68] The effect is to convert a cost-basis transfer into a carryover-basis transfer to the extent of the unallocated premium.[69] The cost-basis buyer

gain rate and by reference to the corporate basis, or at the investor's rate by reference to his basis, whichever produces the higher tax." *Id.* Although difficult to reconcile with the concerns motivating the proposed repeal of the *General Utilities* doctrine, this credit is not directly related to unallocated premium, and therefore will not be further discussed here.

66 ALI Proposal IVB, at 130–31.

67 *Id.* at 125.

68 ALI Proposal IVB, at 130–31.

69 In the context of cost-basis transfers, unallocated premium means goodwill: the value of a business minus the value of its constituent assets. *See id.* at 131–32. Although in other legal applications, including some tax applications, goodwill may be valued separately, *see generally* Note, *An Inquiry into the Nature of Goodwill*, 53 COLUM. L. REV. 661 (1953), the ALI proposals follow the practice of financial accounting, treating purchased goodwill as "the difference between the fair market value of the identifiable assets acquired and the total amount paid." ROBERT N. ANTHONY & JAMES S. REESE, MANAGEMENT ACCOUNTING PRINCIPLES 154 (3d ed. 1975).

would be entitled, in the event of a resale, to whatever adjustment the carryover-basis buyer is entitled to with respect to such premium.[70]

Suppose, to return to the example previously used, that target corporation *X* has tangible assets worth $900 and goodwill worth $100. Vary the facts stated by assuming that the basis of the tangible assets is $900. The basis of the goodwill remains zero. If the business is sold to *P* for $1,000 in a carryover-basis transfer, *X* pays no tax and *P* takes carryover bases in the assets: $900 for the tangible assets and zero for the goodwill. The zero basis in the goodwill is, of course, of no use to *P* in the future. If instead the sale were a cost-basis transfer, *X* would pay tax on the $100 gain and *P* would have a $100 basis in the goodwill. But because the goodwill is nonamortizable under existing law,[71] this basis is also of no use to *P* in calculating its business profits. The ALI Proposals seek to avoid this adverse consequence of electing cost-basis treatment by giving carryover-basis treatment to the $100 (that is, an exclusion of this amount from *X*'s gain, along with a zero basis to *P* in the goodwill), even though the sale is otherwise treated as a cost-basis transfer.

The ALI Proposals point out, in adopting this solution, that "another way to ameliorate the harshness" of taxing a corporate seller on an amount from which the buyer derives no corresponding benefit would be to change the rules that currently deny the buyer any such benefit, that is, to allow the buyer to amortize the cost of goodwill.[72] Indeed, as the Proposals also note, the law in this respect is in "something of a state of flux," with taxpayers now having increasing success

70 ALI Proposal IVB, at 130–31. The interrelation of the retained boot tax and the partial carryover-basis treatment of a cost-basis transfer is further discussed below. *See infra* notes 96–102 *infra* and accompanying text.

71 The general rule prohibiting amortization follows from the placement of the burden upon the taxpayer to prove that the useful life of the goodwill can be estimated "with reasonable accuracy." Treas. Reg. § 1.167(a)-3. In practice, this burden is difficult to overcome, so the procedural rule leads to the substantive result that goodwill is nonamortizable.

72 ALI Proposals, at 125.

in obtaining amortization of at least some intangibles.[73] The Proposals express approval of this trend and would not disturb it. Instead they would offer the partial carryover-basis treatment described above as an alternative, available to the purchaser who is willing to forego any attempt to apply the price paid for goodwill against future corporate income.[74] Such a purchaser would, presumably, negotiate a decrease in the purchase price, the seller being relieved of a corresponding amount of taxable gain on the sale.

There are thus two distinct reasons offered by the ALI Proposals in support of a special treatment of unallocated premium in cost-basis transfers. The first is that relief from tax for the seller is warranted because of the lack of any corresponding benefit to the buyer. This reason would apply to any asset that the buyer does not either sell in the normal course or depreciate; and, indeed, the Proposals explicitly leave open the possibility of similar treatment for premium paid for assets other than goodwill.[75] The second reason is that the relief given to the seller partially remedies a particular defect in the existing law: the nonamortizability of goodwill to the buyer. The respective merits of these two theories are the subjects of the two succeeding sections of this article. The three remaining sections deal with three additional questions presented: first, whether the special treatment of goodwill should be extended to land, a similarly nonamortizable asset; second, whether there should be an exemption rather than a mere deferral of the corporate tax on transfers of

[73] *Id.* The fact that goodwill is defined as a residual causes the amount of goodwill to depend upon the extent to which other assets of the business can be identified and valued. Current tax law allows the "carving out" from goodwill of some separately identifiable assets, such as customer lists. It may be possible to estimate a reasonable useful life for such assets, which will entitle the purchaser to amortize their cost. Also, when current law permits separate valuation of goodwill, the excess of cost over tangible assets plus goodwill so valued may be partly allocated to tangible assets, thereby becoming depreciable.

[74] ALI Proposals, at 125–26.

[75] *Id.* at 127.

goodwill; and third, how the special treatment of goodwill interrelates with the retained boot tax discussed in Part III.B above.

B. *Exemption as a Means of Avoiding an Extra Tax on Transfers*

Although the point is not elaborated on in the Proposals themselves, the notion that no gain should be recognized to the seller unless the buyer benefits therefrom meshes with the Proposals' twin goals of preventing both the escape and the compounding of the corporate tax. A step-up in the basis of assets that are going to be either sold in due course (such as inventory) or depreciated (such as equipment) represents an escape from the corporate tax unless a tax is paid as the price of the step-up, since the amount of the step-up will be subtracted from the taxable income of the ongoing business. This is the reason for the proposed repeal of the *General Utilities* doctrine. This reason does not apply, however, to assets such as goodwill that are neither depreciable nor likely to be sold in the normal course of business. A corporate tax on the increase in the value of such assets at the time of a transfer is unnecessary to prevent an escape of the corporate tax (since a step-up in the basis of such assets will not reduce the taxable income of the ongoing business), and it actually threatens a compounding of the tax in the sense that the gain in question would normally never be taxed to an ongoing business but for a change in its ownership. If the goals are to minimize the tax effect of changes in ownership and to avoid any tax that would not be imposed but for such changes, then an appropriate solution is to exempt sellers from gains on sales of goodwill and other similar assets as well.

It is not clear, however, that these are the appropriate goals. In our tax system changes in ownership generally do make a difference. They are regarded as proper occasions for taxing gains that have previously escaped tax only because of the realization requirement. A taxpayer can accrue wealth yet avoid paying income tax if the wealth stays tied up in assets that do not change hands, but generally the tax must be paid when an exchange is made. Certainly this imposes adverse tax consequences on the exchanging of assets, but the way to avoid such consequences is to eliminate the realization requirement or repeal the capital gains tax. While some have advocated the latter for precisely this reason,[76] the issues of the continued existence of the realization requirement and of capital gains taxation are expressly placed beyond the scope of the ALI Proposals.[77]

One could argue instead for a limited repeal exempting only those gains, such as gains from the sale of goodwill, that occur in a sporadic manner and arbitrarily subject some businesses to a tax that most escape. Where the line would be drawn to effect this distinction is difficult to say. Similar problems are mitigated in the case of most other assets by the potential for higher future depreciation or amortization deductions. As is further developed below, amortization should probably be available for goodwill in any case. Because it would cause goodwill to be treated consistently with other assets, amortization is preferable to exemption as a form of relief. Exemption may serve as a possible substitute for amortization, and as such may represent an improvement over existing law, but it is not an end in itself.

C. *Exemption as a Substitute for Amortization*

The Proposals are justified in their implicit criticism of the treatment of goodwill under existing law. To begin with, the treatment of goodwill differs radically depending on whether it is developed within the business or acquired by purchase. Current practice in both tax accounting[78] and financial accounting[79] allows expenditures on adver-

[76] *See* Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).

[77] ALI Proposals, at 3–4, 7–8.

[78] *See* Rettig, *Tax Recovery of the Cost of Intangible Assets*, 18 J. TAX'N 154 (1963).

[79] *See* ANTHONY & REESE, *supra* note 69, at 52.

tising, research and development, and personnel recruitment and training to be deducted from current income, even though these expenditures, like capital investments, generate benefits that extend to future accounting periods. The goodwill created by these expenditures is thus treated like an asset with a useful life of less than one year. By contrast, tax accounting and financial accounting require purchased goodwill to be capitalized. Although financial accounting requires the amortization of such goodwill over at most a forty-year period,[80] tax accounting generally allows no amortization at all.[81] Purchased goodwill is thus treated like an asset with a useful life of infinite duration.

Because goodwill is a residual asset, it is a hodgepodge. Customer loyalty, brand awareness, access to channels of distribution, supplier relations, government relations, organizational structure, personnel training, labor relations, and technological know-how can all enter into goodwill in varying amounts. Although it is difficult to generalize about such a variety of elements of goodwill, it is probably safe to say that each typically has a limited useful life. While any estimate of the useful life of these elements will be highly uncertain, methods similar to the regulations establishing class lives and asset depreciation ranges for tangible assets[82] could make the problem manageable. A systematically approximated useful life for goodwill is more realistic than an infinite one. For these reasons amortization in some form seems desirable.[83]

The question then arises whether amortization can be effectively offered in the indirect form of an exemption for the seller of goodwill. One way to compare not taxing the seller with giving the buyer

[80] Accounting Principles Board, *Opinion No. 17* ¶ 29 (Aug., 1979). *See also* ANTHONY & REESE, *supra* note 69, at 202–06.

[81] *See supra* note 71.

[82] Treas. Reg. § 1.167(a)-11.

[83] For a more extensive argument in favor of the amortization of goodwill, see Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859, 871 (1968).

an amortization deduction is to calculate how much each tax break is worth. As noted above, one choice benefits the buyer and the other benefits the seller, but presumably differing purchase prices expected under each alternative would cancel the discrepancy. Not taxing the seller is worth 28 cents for every dollar of goodwill exempted, since the current corporate capital gains tax rate is 28 percent.[84] The value of amortization to the buyer is more complicated: it is the present value of the stream of tax deductions generated over the amortization period. This value depends on the ordinary income tax rate, the rate used for discounting future tax savings, and the number of years over which the goodwill is written off.

Assuming a 10-percent discount rate and a 46-percent corporate tax rate, the present value of the right to amortize one dollar of goodwill is worth 28 cents when the period of amortization is about 10 years. Thus, the decision not to tax sellers of goodwill is equivalent, under current law and economic conditions, to allowing buyers to amortize over 10 years. Not taxing sellers can be seen as equivalent to establishing that all goodwill has a useful life of 10 years.

This relationship is shown in the accompanying table, which shows the tax benefits of amortization over various amortization periods, assuming a 10% discount rate and a 46% tax rate. The first column is the amortization period. The second column is the present value of a stream of $1 payments over such a period, as it might appear on a banker's loan charts. The third column is the second column divided by the first; since only a fraction of the dollar of goodwill can be deducted each year, this column represents the present value of the income sheltered by allowing amortization. Because a deduction now is worth more than a deduction later, this column is always less than 1, and declines as the amortization period increases. The fourth column is the third column multiplied by the assumed marginal corporate ordinary income tax rate of 46%; this represents the present value of

[84] I.R.C. § 1201(a)(2).

the taxes saved by allowing amortization. The relationship between the seller's exemption and the buyer's amortization can be seen by noting that the fourth column equals .28 when the amortization period is 10 years.

Tax Benefit of Amortizing $1 of Goodwill

Amortization Period	Present value of $1 received annually	Present value of income sheltered	Present value of taxes saved
1	.91	.91	.42
2	1.74	.87	.40
3	2.49	.83	.38
4	3.17	.79	.36
5	3.79	.76	.35
6	4.36	.73	.33
7	4.87	.70	.32
8	5.33	.67	.31
9	5.76	.64	.29
10	6.14	.61	.28
11	6.50	.59	.27
12	6.81	.57	.26
13	7.10	.55	.25
14	7.37	.53	.24
15	7.61	.51	.23

A tax rule that in effect assumes that goodwill always lasts 10 years fails to take into account aspects of a particular business that may cause its goodwill to be shorter or longer lived. Moreover, the 10-year "equivalent amortization period" will itself fluctuate with a number of other variables. For example, if the discount rate were 5 percent, the equivalent amortization period would be 18 years; if the discount rate were 15 percent, the equivalent amortization period would be 5 1/2 years. Equally crucial are the relative tax brackets of the buyer and seller. The 10-year period mentioned above is calculated on the basis of the current relationship of corporate ordinary income and capital gains rates, the latter being currently 61 percent (28/46) of the former. If, however, corporate capital gains were taxed at 50 percent of the ordinary income rate, the equivalent amortization period would be slightly more than 15 years. If, conversely, capital gains were taxed at 80 percent of the ordinary income rate, the equivalent amortization period would be just under 4 years. If the capital gains preference were to disappear, the equivalent amortization period would be zero: not taxing the seller would be just like giving the buyer an immediate deduction. If the exemption of proceeds from the sale of goodwill were extended to transactions involving individuals, the equivalent amortization period would depend on the nature and amount of other income of the parties, and would thus fluctuate widely even without changes in the discount rate or the tax law. Needless to say, none of the fluctuations described above has anything to do with the expected useful life of goodwill.

Because of the potential for arbitrary fluctuations in the equivalent amortization period, it would be preferable for Congress to allow amortization directly, rather than to try to accomplish a similar result indirectly by not taxing sellers of goodwill. Yet even this indirect method is preferable to the more unrealistic assumption of current law that goodwill lasts forever.[85]

D. *Goodwill versus Land*

The ALI Proposals explicitly take up the question of whether land should receive the same treatment as goodwill in a cost-basis transfer. Land, like goodwill, generates no depreciation or amortization deductions. A stepped-up basis in land, therefore, will not decrease taxes on

85 Although a uniform amortization period for the buyer is better than exempting the seller from tax, a non-uniform amortization period may be still better. The analysis here simply ranks a seller's exemption somewhere between current law and uniform buyer amortization.

the purchaser's operating income. Also, like goodwill, "change in land value is often never realized at the corporate level, and taxing it when it is will tend to impose a capricious burden on some corporations that others will never bear."[86] Given these similarities, one would expect similar tax treatment, particularly if the proper justification were to avoid imposing an extra tax merely because of a change in ownership. The ALI Proposals appear to assume that this is the proper justification, and yet they refuse to extend to land the favorable treatment proposed for goodwill,[87] giving a number of reasons for such refusal. The refusal may be warranted, but not for the reasons given.

The first reason given is that expenditures that enhance the value of land can shelter operating profits. Expenditures to improve farmland, as well as interest and property taxes related to farm and nonfarm landholdings, can be deducted even though they are made with a view to future appreciation rather than current income. The ALI Proposals correctly note that a recapture rule for these expenses would be unduly complicated. Yet precisely the same is true for goodwill. Advertising, research and development, and personnel development expenditures may be deducted currently even though they build up goodwill. If the Proposals tax gains from the sale of land in order to ensure at least partial recapture of past deductions, then the same reasoning would lead to taxation of the proceeds from the sale of goodwill.

The ALI Proposals make another point about land that is hard to dispute:

> In a world in which land is one available investment, and appreciation in value is part of the return to be expected from that investment, exemption of that return will introduce undesirable distortions. Of course, long-term deferral on land appreciation and capital gain treatment give land appreciation a tax advantage over

86 ALI Proposals, at 134.

87 *Id.* at 134–35.

> other kinds of business profit in any event, but the possibility of outright exemption from corporate tax would tend to aggravate the resulting distortion.[88]

Goodwill is another such form of investment, and to many venture capitalists, eventual realization of the proceeds of the sale of goodwill is a substantial motivation for investment. If land sales are to be taxed to corporations for this reason, so must sales of goodwill.

It should be noted, of course, that land is not always a capital asset. Corporate dealers in land, for example, realize ordinary income upon its sale. The capital gains preference requires a determination as to when land is a capital asset in the hands of the seller. In this respect, land truly differs from goodwill, since goodwill is always a capital asset. Extending to land the favorable treatment proposed for goodwill would raise the stakes on the dealer issue: a dealer would pay tax at ordinary rates, while others would pay no tax at all.

There is a more persuasive ground for distinguishing land from goodwill, which the ALI Proposals overlook. Land, unlike goodwill, really does last forever, or at least for a good long time. As argued above, the strongest reason for exempting sales of goodwill from tax is to provide indirectly the benefits of amortization. The justification for such a benefit stems from the judgment that the useful life of goodwill is typically limited. No such judgment can be made regarding land. Exempting gains from sales of land is equivalent, under the logic and conditions discussed above, to giving the buyer the right to depreciate land over 10 years. This is rapid depreciation for an asset whose useful life is for all practical purposes infinite. Thus the primary justification for favorable treatment of goodwill does not apply to land. In drawing a distinction between land and goodwill, the ALI Proposals are right even if for the wrong reasons.

88 *Id.* at 135.

E. *Deferral versus Exemption*

Carryover-basis treatment ordinarily implies only a deferral of tax. Thus, when one corporation purchases goodwill from another, taking a carryover (usually zero) basis therein, it ostensibly accepts at least the potential liability for a corporate tax on the unrealized gain. In our example, *P*'s zero basis in the $100 worth of goodwill that it has acquired exposes it, at least potentially, to a tax on that amount if the goodwill is ever sold.

In fact this tax will never be paid while the business remains in corporate solution, for there will always be nonrecognition and a carryover of basis as between corporate buyers and sellers. Yet if goodwill were given the same carryover-basis treatment that other assets receive (when full carryover-basis treatment applies, for example), the tax would be imposed when the business passed out of corporate solution. One would expect, therefore, that when the business was sold by a corporation to an individual or partnership, the ALI Proposals would not forgo this last opportunity to impose the corporate tax.

Surprisingly, the ALI Proposals do forgo it. In a conscious restriction of the scope of the corporate income tax, they allow a corporate seller to exclude the gain attributable to goodwill regardless of whether the buyer is a corporation or not, the only requirement being that the sales proceeds be distributed to the seller's shareholders.[89] The Proposals thereby convert the deferral of the corporate tax on increases in the value of goodwill into a complete exemption.

The reason given by the Proposals for thus removing the proceeds of sales of goodwill from the corporate tax base is that these proceeds do not represent "operating profits during the period of corporate ownership," but rather represent "the capitalization of fu-

[89] *Id.* at 128–29.

ture, noncorporate profits."[90] This conclusion is open to question for several reasons.

First, such a characterization of the proceeds of a sale of goodwill may be wrong as a factual matter. Given the liberal deductibility of expenditures that enhance goodwill, such as advertising, the proceeds of a sale of goodwill may in fact be not the capitalization of future, non-corporate profits but the realization of past, corporate profits. Good-will sales may have to be taxed simply to insure the integrity of the corporate tax as a tax on operating profits in the narrowest sense.[91]

Even if goodwill were thought to arise not from deductible expenditures but from the fact that the corporation was in the right place at the right time, either from good planning or good luck, the value of the goodwill would nevertheless be the result of past actions and events that have brought the business to its current favored position. Such an appreciation in value, representing the success of the corporation's actions and the favorability of events over the period of corporate ownership, would seem to be aptly described as an "operating profit," although unrealized, until the time of sale. If this appreciation is not an operating profit, then neither are any number of other corporate capital gains. Yet to exempt all such gains on sales to individuals would leave an intolerably large loophole in the definition of corporate income.

Even if gains in the value of goodwill were considered to be something other than operating profits, it is not clear why only those gains that do constitute operating profits should be taxable to a corporation. The individual income tax is generally imposed without regard to the source of the income.[92] No reason appears why the same nondiscrimination rule should not apply to corporations. The

[90] *Id.* at 129.

[91] Insuring this integrity is a goal that the proposals explicitly espouse. *Id.* at 10.

[92] *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 170 (1938). *See also* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 385 (1972).

departure by the ALI Proposals from this principle is particularly surprising in light of their careful efforts in other contexts to protect the corporate tax base.

To be sure, it is a condition of the exemption of the corporate seller, under the ALI Proposals, that the proceeds of a goodwill sale be currently distributed and taxed to the shareholders. The corporate income tax is not, however, generally regarded as an alternative to the personal income tax. Indeed the Proposals assume that the two taxes will continue to be imposed, and no fundamental reform is undertaken to integrate them.[93]

The relationship between the two levels of tax is addressed in greater depth in Tentative Draft Number 2 of the ALI Proposals, dealing with corporate distributions. There also a general integration is eschewed. On the contrary, a theory is adopted that holds that both a corporate and a shareholder level tax must be imposed in order to preserve at least a rough balance between the tax burden imposed on those income-producing assets that are held in corporate solution and those that are withdrawn from it.[94]

93 ALI Proposals, at 6–7.

94 *See* ALI Proposals, Draft No. 2, at 5–7, 26–27, 96–99. A simple illustration will make the point. Suppose that assets worth \$100 are held in corporation *X*, which is owned by shareholder *Y*, and that the assets will yield 20% in profits over the next year. Make the further assumption, unrealistic but useful for illustrative purposes, that all tax rates are 50%. If the assets are distributed to *Y* before the profit-making period, he will receive assets worth \$50 net of tax. He will then make \$10 in profits during the period, and, after paying tax on this income, have \$55 in value left. If instead the assets are left within the corporation during the profit-making period, they will earn \$20. If they are then distributed along with the income, the result to *Y* will be the same as if the assets had been withdrawn at the start of the period, for the corporate tax will reduce the profits from \$20 to \$10, and the net pay-out to *Y* will be \$55 (50% of \$110). This balance is upset, and a bias introduced in favor of holding assets in corporate solution, if the corporate tax is not paid, for *Y* would then receive \$60 (50% X \$120); It makes no difference in this example that the shareholder tax and corporate tax may be paid at the same time (on distribution at the end of the period), or that the profits in question may be attributable to an increase in the value of goodwill. *See also* Joseph E. Stiglitz, *Taxation, Corporate Financial Policy and the Cost of Capital*, 2 J. PUB. ECON. 1 (1973).

In Draft Number 1, the Proposals state that "there is no *a priori* reason ... for starting with a presumption that the [corporate income] tax should embrace all ... gains."[95] Draft Number 2 may provide just such a reason, by pointing out the interdependent roles played by the corporate and shareholder level taxes. The project participants planned to reconcile earlier drafts with later developments at the conclusion of the project. Such reconciliation may well require reversal of the current proposal exempting corporations from tax on sales of goodwill.

F. *The Retained Goodwill Proceeds Tax*

As previously noted, the proposed exemption for gains on sales of goodwill is available only to the extent that the transferor distributes the proceeds of sale to its shareholders. The result, when all or part of such proceeds are retained, is a tax on the seller that is similar to the retained boot tax.[96] In keeping with their perception that the special treatment of goodwill proceeds amounts to partial carryover-basis treatment, the ALI Proposals would grant to the buyer of goodwill the same adjustment to basis for resale purposes that the carryover-basis buyer is in general entitled to, the exact nature of this adjustment being uncertain.[97]

To illustrate with the example used above, if target corporation *X* were to sell all its assets for $1,000 on a cost basis, it could exclude from its gain of $350 the $100 allocated to goodwill, provided that acquiring corporation *P* agreed to this allocation. *X* would, however, pay tax on any part of the $100 that it received, either in cash or *P* stock, that it did not currently distribute to its shareholders. *P* could not make any use of, the $100 in subsequent income computations,

[95] ALI Proposals, at 9.

[96] *See supra* text accompanying notes 52–60.

[97] ALI Proposals, at 130–31.

except that it might have an adjustment of basis upon resale.[98] *P*'s treatment in these respects would be unaffected by whether or not *X* has paid a tax on the transfer.

The principal difference between the retained boot tax and what may be called the "retained goodwill proceeds tax" is that the latter is imposed on all retained proceeds, whether stock or boot. This difference apparently flows from the different justifications given by the ALI Proposals for the two taxes. The retained boot tax is imposed on the theory that carryover-basis treatment should be denied where there has been disinvestment and yet no tax paid at the shareholder level, the amount of boot being the measure of such disinvestment.[99] The rationale of the retained goodwill proceeds tax is nowhere spelled out in the Proposals. The Proposals first state that an unallocated premium reflecting goodwill should be given carryover-basis treatment because of the similarity between such a premium and the premium paid by a purchaser in a straight stock purchase.[100] Without further elaboration the Proposals then proceed to exempt a corporate seller on the gain attributable to goodwill only if all proceeds attributable to goodwill are distributed to shareholders. The notion, apparently, is that only such distributed proceeds exactly resemble a premium paid in a stock purchase, and since this resemblance is the basis for the exemption, it should not apply to any proceeds not so distributed.

It is not clear that the justification thus offered for taxing all retained goodwill proceeds is adequate. A central thesis of the ALI Proposals is that the payment or deferral of the corporate tax should be elective, unless there is a substantial reason to deny deferral.[101] Dis-

[98] As noted above, *P* would probably not be taxed upon resale on what it received for the goodwill, regardless of what the resale basis adjustment might be. *See supra* text accompanying note 89.

[99] *See supra* text accompanying notes 53–55.

[100] ALI Proposals, at 123–26.

[101] *Id.* at 39.

investment without tax may be such a reason, but this reason does not apply to the retention of purchaser stock within the selling corporation. If the premium paid for goodwill is in the form of purchaser stock, the investment of the selling corporation's shareholders in the business remains intact to that extent, and it makes little difference whether the investment is held directly by the shareholders, or indirectly through the selling corporation.

An affirmative reason not to tax a transferor on goodwill proceeds is that such a tax defeats the policies that underlie the special treatment of goodwill. As noted above,[102] a tax on the seller of goodwill threatens to compound the corporate level tax by imposing a burden that would not be borne at all by the ongoing business, but for a change of ownership. To the extent that such a tax is paid, moreover, there is no relief for the seller from the non-amortizability of an asset that typically has a limited useful life. If these policies were regarded as sufficiently important, they would override entirely the reasons for taxing a transferor on the retained proceeds of a sale of goodwill. The policies at least suggest that the tax should only be imposed when there is a complete disinvestment by the transferor's shareholders. It should fall, in short, only on retained boot.

Finally, for the reasons given in Part III.B, whatever corporate level tax is imposed on the seller on the proceeds of a sale of goodwill should result in a step-up in the basis of the goodwill. To that extent the buyer may attempt to amortize his cost as far as possible under existing law. The step-up will also reduce his gain on resale, a point that is only relevant if the suggestion of this article is accepted that this gain should not be exempted on sales to non-corporate purchasers.

[102] *See supra* text accompanying notes 76–77.

G. *Summary*

To summarize, the ALI Proposals grant complete relief from the corporate tax on gains in the value of goodwill that are realized on transfers of the business. Some relief is appropriate, especially to remedy the unrealistic assumption of current law that goodwill lasts forever. Offering a total exemption rather than a deferral, however, seems overly generous, since there is no reason that gains in the value of goodwill, as distinct from other returns on investment, should be removed entirely from the corporate tax base.

On the other hand, the proposed tax on all retained proceeds of goodwill seems overly severe. Any tax on the transferor diminishes the relief offered for purchased goodwill, and should therefore be limited to a tax on retained boot attributable to goodwill. If goodwill were amortizable, of course, the normal mechanism of a step-up in basis would suffice, and most of the problems discussed in this section would disappear. Amortizability is the best solution, but the special treatment of goodwill offered by the ALI Proposals, with the modifications suggested here, is at least an improvement upon existing law.