DESCRIPTION OF S. 2687 AND S. 2547

Relating to

TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS

Scheduled for a Hearing

on July 15, 1982

By the

Senate Committee on Finance

Prepared by the Staff

of the

Joint Committee on Taxation

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INTRODUCTION

This document provides a description of the provisions of S. 2687 (Senator Danforth) and S. 2547 (Senator Metzenbaum), relating to the tax treatment of corporate mergers and acquisitions. These bills are scheduled for a public hearing on July 15, 1982, by the Senate Committee on Finance.

The changes included in S. 2687 correspond to those approved by the Committee on Finance in its amendment to H. R. 4961 (secs. 226-227 and 229 of the bill as reported; S. Rept. No. 97-494,Vol. 1, July 12, 1982).

The first part of the document is a summary of principal changes made by the bills compared to present law. This is followed by a more detailed description of the provisions of the bills and present law.

Summary of Principal Changes Made by S. 2687 and S. 2547

Subject	Present Law	S. 2687[1]
Treatment of corporation distributing property in partial liquidation	Gain or loss not recognized to corporation but recapture rules apply.	Same, if distribution is made without redeeming stock from shareholders. Gain recognized if stock is redeemed.
Treatment of shareholders on partial liquidation	Gain or loss recognized with respect to stock redeemed, generally capital gain or loss.	Same only if there is a non-pro rata stock redemption. If stock is redeemed pro rata, or the property is distributed without redeeming stock, generally will be a dividend to shareholders. Capital gain treatment preserved for noncorporate shareholders where 5-year old trade or business is distributed pro rata. S. 2547 would provide such treatment to corporate shareholders as well.
Nonliquidating redemptions of stock for appreciated property	Gain or loss, generally capital gain or loss, to shareholders if redemption is not pro rata. If pro rata, may be a dividend. Gain but not loss, is recognized to corporation but with several exceptions.	Same, but most exceptions to the requirement that gain is recognized to the corporation would be repealed.
Stock purchase treated as asset purchase	Applies where 80 percent of acquired corporation's stock purchased by purchasing corporation within one year and subsidiary is liquidated. May take up to 5 years after stock purchase to liquidate, but plan to liquidate must be adopted within 2 years of purchase.	Within 75 days after qualifying stock purchase, purchasing corporation may elect to treat transaction as if subsidiary sold all its assets on stock purchase date and is thereafter a new corporation which bought the assets. No actual liquidation required.

1/ All changes proposed by S. 2687 correspond to those agreed to by the Finance Committee at an executive session on July 1 and 2, 1982.

2/ These changes are proposed in both S. 2687 and S. 2547. No other changes are proposed by S. 2547.

Summary of Principal Changes Made by S. 2687 and S. 2547

Subject	Present Law	S. 2687
Purchase of assets from corporation and purchase concurrently of the selling corporation's stock	If acquired subsidiary is not liquidated under the asset purchase rule, transaction is both an asset purchase and continuation of subsidiary.	Transaction will be treated as wholly an asset purchase, as if election made with respect to purchased subsidiary.
Purchase of several corporations that are members of the same affiliated group	By complying with asset purchase rules, liquidation of one or more corporations may be treated as asset purchases while continuing one or more other corporations.	Must elect to treat all acquired affiliates as if assets were sold or treat all acquired corporations as continuing.
Purchase of assets from a corporation and purchase of the stock of an affiliated corporation	Asset purchase plus continuation of the acquired subsidiary if it is not liquidated under the asset purchase rules.	Deemed to be entirely a purchase and sale of assets as if election made for acquired subsidiary.

Under S. 2687, the effective date for the changes relating to the treatment of partial liquidations and stock redemptions apply in the case of distributions after August 31, 1982. Changes relating to the treatment of stock purchases as asset purchases apply where the date of acquisition (of 80 percent or more of the acquired corporation's stock) occurs after August 31, 1982. The effective dates of the changes agreed to by the committee are the same except that the changes relating to the treatment of partial liquidations would not apply to distributions pursuant to a plan of liquidation adopted on or before October 1, 1982, by a corporation a majority of the shares of which were acquired pursuant to a tender offer outstanding on July 1, 1982, or a binding contract entered into before that date. S. 2547 applies with respect to distributions after May 19, 1982 (the date of the bill's introduction).

S. 2687--Senator Danforth

and

S. 2547--Senator Metzenbaum

Overview

The provisions of S. 2687 are intended to accomplish the following objectives:

1. If a distribution to shareholders of appreciated property by an ongoing corporation with continuing tax attributes is treated as a taxable exchange of stock by the shareholders, gain should be recognized by the distributing corporation to the same extent as would be required on a direct sale of the assets. S. 2547 is also addressed to this objective.

2. The basis of purchased assets is their cost, generally current fair market value, and they carry none of the tax attributes of the selling corporation. The basis of assets and other tax attributes of an acquired corporation are unaffected by the purchase of its stock. Consistency of treatment should be required in corporate takeovers to eliminate any tax advantage in selectively structuring the acquisition as in part a purchase of assets and in part a purchase of stock.

3. A purchase of one corporation's stock by another corporation may be treated as a purchase of the acquired corporation's assets under present law if the acquired corporation is liquidated in accordance with certain statutory requirements. Compliance, or failure to comply, with those requirements makes such treatment essentially elective. The tax attributes of the acquired corporation continue until it is liquidated. Elective treatment should be expressly provided rather than implicit and asset purchase treatment if elected should apply as of the time the stock is purchased in order to equate asset purchase treatment with an actual asset purchase. Such elective treatment should not require an actual liquidation.

S. 2547 and TITLE I of S. 2687

In general

S. 2547 and Title I of S. 2687 require a corporation that distri butes appreciated property in redemption of part of its stock to recognize gain, as it would be required to do if it sold its assets.

Partial Liquidations--Background

Principally S. 2547 and Title I of S. 2687 affect transactions that qualify as partial liquidations under present law. A distribution of assets by a corporation in redemption of its stock qualifies as a partial liquidation if it results in a significant contraction of the distributing corporation's business operations. There is no gain or loss recognized to the corporation except for recapture tax with respect to prior depreciation, investment tax credit, and other items. Gain or loss to the shareholders resulting from the exchange of part of their stock for the assets in most cases is capital gain or loss. The fair market value of the distributed assets at the time of distribution becomes the basis to the shareholders.

If one corporation purchases stock of another and thereafter receives a distribution of business assets in a redemption of the purchased stock in a transaction qualifying as a partial liquidation, the transaction is similar to a direct purchase of the assets except that the distributing corporation is not required to recognize gain. If one corporation acquires control of another (80 percent of the stock) and consolidated returns are filed, recapture tax is deferred or avoided on a partial liquidation of the acquired corporation under the regulations.

The partial liquidation provisions may be used to selectively step up the basis of assets in an acquired subsidiary to obtain increased depletion and depreciation deductions and other tax benefits without recognition of gain. For example, assume a subsidiary corporation has two groups of assets. One group of assets has a low basis due to prior depletion deductions and no potential recapture tax liability. The other group of assets has a large recapture tax potential. To obtain increased depletion deductions on the first group and avoid recapture on the second group, S distributes the first group of assets to P in a transaction that qualifies as a partial liquidation. No tax is paid by S on the transaction and P gets a stepped-up basis in the distributed assets that will permit increased depletion deductions. The tax attributes of S are unaffected and P continues to have control over the S assets. The transaction thus permits the step-up in basis that would occur if the assets were purchased by P but does not impose the tax against S that would apply if the assets were sold by S. If the assets were distributed as a dividend by S, the disparity of treatment would not occur. Gain would not be recognized to S but P would not get a stepped-up basis (the basis of assets distributed to a corporate shareholder as a dividend is limited to the distributor's basis adjusted for recapture items).

A partial liquidation, whether or not it is within a corporate takeover context, often resembles a normal corporate dividend where the distributing corporation has sufficient earnings and profits, the distribution is pro rata among the shareholders, and the distributing corporation remains as a continuing business enterprise.

Proposal

The change proposed by S. 2547 and Title I of S. 2687 repeals the partial liquidation provisions of present law except that it preserves capital gain treatment for noncorporate shareholders in a limited case, i.e., where the distribution results from the corporation's ceasing to conduct a 5-year old trade or business and the distributing corporation continues to conduct a separate 5-year business.3/ For other distributions now classified as partial liquidations, repeal will result in a dividend. The distributing corporation making an in-kind dividend is taxed on recapture items but does not recognize gain otherwise. A corporate shareholder receiving an in-kind dividend has a carryover basis for the distributed assets and thus the transaction does not resemble a purchase of assets stepping up basis without gain recognition. Basis of assets distributed as a dividend to noncorporate shareholders do acquire a fair market value basis but the full amount of the distribution constitutes ordinary income to the shareholders.

Stock Redemptions--Background

Under present law, when a corporation distributes appreciated assets to one or more shareholders in redemption of part of its stock in a transaction not qualifying as a partial liquidation, gain is generally recognized both to the distributing corporation and to those shareholders exchanging their stock. There are several exceptions to the requirement that gain must be recognized to the distributing corporation. These exceptions permit a basis step-up on the one hand as though the assets were purchased by the shareholders, and no gain recognition on the other, as though the assets were distributed in the normal course of the corporation's business. These exceptions put a premium on having asset distributions take the form of stock redemptions.

To illustrate, one such exception applies where the distribution consists of stock in a subisdiary corporation more than 50 percent owned by the distributing corporation. If stock in the subsidiary corporation were sold directly by the parent corporation, taxable gain would be recognized to the parent. Instead, the buyer might purchase stock in the parent and thereafter receive the subsidiary's stock in a distribution redeeming the parent's stock. The transaction is essentially similar to a direct sale of the subsidiary's stock except that, under the described exception, the parent corporation is not required to recognize gain.

If a stock purchase followed by its redemption for appreciated property are pursuant to a plan, present law may result in treating the transaction as a direct purchase of assets. This

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3/ S. 2547 would preserve capital gain treatment for corporate shareholders as well in these cases.

treatment is clearly inapplicable to many stock redemptions and its application in other cases will remain uncertain unless mandated by statute.

Proposal

The bills would repeal most of the exceptions to the provision that requires gain recognition to the distributing corporation on a distribution of appreciated property in a stock redemption.

General Effect of S. 2547 and Title I of S. 2687

The repeal of the partial liquidation rules and the exceptions to the requirement that gain be recognized on distributions of appreciated property in stock redemptions will provide greater tax neutrality between corporate acquisitions through stock purchases and through direct asset purchases.

TITLE II of S. 2687

In general

Title II of S. 2687 would permit a corporation, after a purchase of the stock of a target corporation, to elect to treat the target corporation as if it sold all its assets in the course of a complete liquidation. Consistency of treatment would be required where several affiliated corporations are purchased or both stock purchases and direct asset purchases are made from the same affiliated group.

Stock Purchase Treated as Asset Purchase--Background

Under present law, when a corporation sells its assets and distributes the proceeds in a complete liquidation, gain is not recognized by the liquidating corporation except for recapture items, and the purchaser obtains a fair market value basis in the purchased assets. To obtain nonrecognition treatment, the sale and liquidation must occur within a one-year period.

Gain also is not recognized by the liquidating corporation if instead of purchasing the assets directly from the liquidating corporation, a corporate purchaser buys 80 percent or more of the stock of the corporation and then liquidates it. The basis in the assets is stepped up to reflect the purchase price of the stock. In effect, the stock purchase is treated as an asset purchase. However, unlike the rules requiring that sales in liquidation occur within a one-year period, the rules governing liquidation of a recently purchased subsidiary do not require liquidation until 5 years after the stock acquisition. The acquired subsidiary has two years to adopt a plan of liquidation and three years after adoption of the plan to actually liquidate. During the interim, the acquired corporation is affiliated with its parent and is included on the latter's consolidated return if one is filed. The bases for the subsidiary's assets and its other tax attributes continue. Because of interim earnings, distributions, sales of assets and other items by the acquired corporation between the stock purchase and ultimate liquidation, complex adjustments are required that lead to inappropriate results in some cases. Recapture income of the subsidiary may be offset against losses of the acquiring corporation on a consolidated return, a result unavailable when assets are directly purchased.

With the exception of the treatment of a liquidation of a recently purchased subsidiary, the treatment of a purchase of assets from a corporation and the treatment of a purchase of a corporation's stock are different. A purchase of assets results in a stepped-up, fair market value basis whereas a purchase of stock that is not followed by a liquidation does not affect the basis of the acquired corporation's assets. A purchase of assets generally carries none of the other tax attributes of the selling corporation whereas those attributes continue and may be exploited on a consolidated return when one corporation acquires control of another. To maximize the tax advantages in a corporate takeover, selectivity can be fostered by structuring the transaction as partly a purchase of assets and partly a stock purchase or, through having the seller form itself into several corporations, as a purchase of several corporations with some being treated as asset purchases via qualifying liquidations while preserving asset basis and tax attributes in others.

Proposal

Title II of S. 2687 would replace the present law provision treating a stock purchase as an asset purchase with an election, to be made within 75 days after 80 percent or more of the acquired subsidiary's stock is purchased, to treat the acquired subsidiary as if it sold all its assets in a complete liquidation on the stock purchase date. No actual liquidation would be required. The basis of the assets would be adjusted to reflect the cost of the stock as of the stock purchase date and other tax attributes of the acquired corporation would terminate as of that date. The subsidiary would be treated as a new corporation that purchased the assets and only the "new" corporation would join in the acquiring corporation's consolidated return. The interim adjustments required under the existing rules treating subsidiary liquidations as asset purchases would not be required.

In addition, Title II requires consistency of treatment where the same corporation, or the same affiliated group, either purchases assets directly plus a controlling stock interest or purchases two or more corporations from the same selling group. This consistency would be required for purchases over a limited period of time, generally one year. Under this rule, purchases of assets generally would be controlling and require asset purchase treatment with respect to stock acquisitions. Where there are no direct asset acquisitions, but several subsidiaries are acquired, a consistent election would be required and, if asset acquisition treatment is not elected for the first subsidiary acquired, could not be made for subsequent acquisitions.

Revenue Effect

It is estimated that the provisions of S. 2687 would increase budget receipts by$693 million in fiscal year 1983, $824 million in fiscal year 1984, $745 million in fiscal year 1985, $661 million in fiscal year 1986, and $572 million in fiscal year 1987.