DESCRIPTION OF THE CORPORATE TAKEOVER TAX ACT OF 1982

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Corporate Takeover Tax Act of 1982

Title I

1. Present law

Partial liquidations.--If a corporation seeks to acquire assets from a second corporation, a direct purchase results in taxation to the second corporation of any gain realized on the sale. Instead, the acquiring corporation, through a tender offer, may acquire stock of the second corporation and then have it redeemed for the assets. If the redemption qualifies as a partial liquidation, generally requiring a contraction of the second corporation's business, the second corporation pays no tax on the gain except to the extent that prior depreciation, intangible drilling costs, etc., are required to be recaptured. When the acquiring corporation obtains control (80 percent of the second corporation's stock), the acquiring and acquired corporations become eligible to file a consolidated return and the consolidated return regulations make it possible through a partial liquidation to obtain a basis step-up for distributed assets with no gain recognized except that recapture gain (for past depreciation, intangible drilling costs, etc.) is recognized but, under the regulations, deferred while the property remains in the consolidated group. Further, there is no investment tax credit recapture when property is transferred from one member of a consolidated return group to another.

Stock redemptions.--In other cases, gain is generally recognized when a corporation redeems its stock with appreciated property but there are exceptions, two of which are particularly relevant in takeover situations, i.e., a distribution in complete redemption of a 10-percent stockholder and a distribution of a 50-percent owned subsidiary.

2. Statement of problem

The vagueness of the "partial liquidation" concept permits considerable discretion in selecting assets that can be stepped up with favorable tax consequences and without affecting the tax attributes of the distributing corporation. Thus, one problem is undue selectivity. A second problem is avoidance of gain recognition on what is in substance a sale of assets. A third problem is the availability of a basis step-up without current taxation of recapture income and without investment tax credit recapture. (The third problem is dealt with generally under title II of the bill.)

3. Bill provisions

Title I of the bill would repeal the partial liquidation provisions as well as certain exceptions in section 311(d)(2) of present law that permit a corporation selling its subsidiary's stock to escape taxation of the gain. Capital gain treatment would be retained for shareholders who receive property from a trade or business conducted for at least 5 years by the distributing corporation (currently defined as a partial liquidation). In appropriate circumstances, a series of distributions in complete liquidation of a corporation, defined under present law as a partial liquidation, will continue to be treated as a complete liquidation.

Section 336, as amended by the bill, would continue to provide for nonrecognition of gain or loss to a corporation on distributions in complete liquidation. However, if within 5 years of a complete liquidation, either (1) there was a distribution qualifying under section 355 and the liquidating corporation is either the controlled corporation or the distributing corporation, or (2) the liquidating corporation transferred property within such period (other than a de minimis transfer) in a transaction in which gain or loss was not recognized under section 351, gain or loss will be recognized to the liquidating corporation. This gain recognition requirement would not apply, however, to the complete liquidation of a subsidiary in which the basis of distributed assets is carried over to the parent.

4. Effective date

The amendments made by title I of the bill apply to distributions occurring after August 31, 1982.

Title II

A. Stock purchase treated as asset purchase

1. Present law

When one corporation purchases 80 percent or more of the stock of a second corporation during a 12-month period and then liquidates it, the transaction is treated as a purchase of assets and basis is stepped up without recognition of any gain but recapture is required for past depreciation, etc. This treatment is available even though the plan of liquidation need not be adopted until 2 years after the qualifying stock purchase and the liquidation need not be completed for an additional 3 years. In the meantime, the acquired company's tax attributes, such as loss and credit carryforwards, can be used on the acquiring company's consolidated return, and, when liquidated, the acquired company's recapture income can be offset by any losses of the acquiring company.

2. Statement of problem

If the assets were purchased directly, the acquiring company would be unable to avail itself of the purchased company's tax attributes and recapture income taxed to the selling company could not be offset by losses of the acquiring company. Continuation of the acquired corporation's tax treatment in the manner permitted by existing law is inconsistent with treating the transaction as an asset purchase but can go on for as long as the parties wish, up to the 5-year limit.

3. Bill provisions

Section 201 of the bill would replace the provision of existing law with an election treating a purchased subsidiary as if it had sold all its assets when the qualifying stock purchase occurred. Since, as the "old" corporation, it would be considered terminated on such date, its tax attributes would not be available on the purchasing company's consolidated return. Generally, the election would apply to all members of an affiliated group after a qualifying purchase of the stock of the parent corporation. A conforming amendment to existing law would require that all members of an affiliated group be liquidated when any member elects nonrecognition of gain or loss on sales made in the course of a 12-month liquidation. The preceding provisions are designed to restrict selectivity of treatment for particular assets and thereby provide consistent treatment for all assets involved in an acquisition or liquidation.

4. Effective date

The elective provision added by section 201 of the bill applies where the qualifying stock purchase takes place on or after September 1, 1982. The amendment with respect to 12-month liquidations would apply to plans of liquidation adopted on or after September 1, 1982.

B. Toll charge for basis step-up

1. Statement of problem

Taxpayers should not be able to frustrate the objectives of the bill by resort to other provisions of existing law. A principle that the other rules in titles I and II reflect is that the cost for a step-up in basis for an acquired corporation's assets is complete recapture, with no deferral, for investment tax credits past depreciation, intangible drilling costs, etc.
A second principle is that a distribution of assets by an ongoing corporation may result in a basis step-up only if all gain (not merely recapture items) with respect to such assets is recognized.

2. Bill provisions

Section 202 of the bill would state these two principles as explicit rules of law overriding the provisions of existing law, including the consolidated return regulations, to the extent they otherwise would permit avoidance or deferral of recapture or gain recognition. Current recapture will be required when basis is stepped up to the same extent as though the liquidating corporation sold all its assets in a single transaction to which section 337 applies.

3. Effective date

The amendments made by section 202 apply to distributions on or after September 1, 1982.

Title III

A. Special limitations on loss and credit carryovers

1. Present law

Present law provisions restricting the carryforward of losses and credits of a corporation after a change in ownership are ineffective. Continuation of the loss company's trade or business after its stock is purchased preserves the carryforwards and, when a loss company is a party to a merger or other reorganization, a minimal retention of ownership by the loss company's shareholders in the surviving corporation may result in retention of carryforwards. The 1976 Tax Reform Act revised these rules but widespread criticism of that provision has led to several postponements of its effective date. Currently, the 1976 revision is scheduled to become effective in 1984.

2. Statement of problem

More effective rules to restrict trafficking in loss companies should be part of any legislation dealing with unwarranted incentives for takeovers. The investment incentives provided by the 1981 Act, particularly the accelerated cost recovery system and investment tax credit provisions, will increase the number of takeover targets with loss carryforwards and excess credits.

3. Bill provisions

Section 301 simplifies the rules, making availability of carryforwards dependent on continued ownership of those who were shareholders in the loss year, unlike existing law or the 1976 revision which measure ownership changes over a limited look-back period from the carryover year.

If loss year shareholders retain a 60-percent interest in the carryover year, carryforwards are unaffected and if their interests fall below 20 percent, carryforwards are eliminated. Carryforwards are reduced by 2.5 percent for each one percentage point by which the loss year shareholders' interests drop below 60 percent. Complete elimination at 20 percent correlates with the point (80-percent ownership) at which tax attributes of an acquired company become fully available to a takeover company on a consolidated return.

The rule applies uniformly whether changes in ownership result from stock purchases, reorganizations, or otherwise (such as a non-pro rata redemption or spin-off), and only changes resulting from death or by gift are expressly excepted.

To facilitate comparison of ownership between the loss year and carryforward year, the rule requires identification only of shareholders whose interests are 5 percent or greater, applying constructive ownership rules. Comparison of the aggregate ownership by shareholders with less than 5 percent interests would be made as if all such shareholders, without identification, constituted a single shareholder.

4. Effective date

The amendments made by section 301 of the bill would apply generally to stock acquisitions and reorganizations occurring on or after January 1, 1983. Transitional rules are provided to integrate the new rules with the provisions of prior law.

B. Reorganizations constituting changes in form

1. Present law

Existing law defines as a reorganization "a mere change in identity, form, or place of organization, however effected" (hereafter described as an "F" reorganization). Existing law also requires that the taxable year of a transferor corporation in a reorganization be closed on the date of transfer and precludes the acquiring corporation from carrying back a post-reorganization loss to a taxable year of the transferor corporation. However, F reorganizations are excepted from these limitations in recognition of the intended scope of such reorganizations as embracing mere formal changes which do not require that the reorganized corporation be viewed as a new entity.

2. Statement of problem

A number of court decisions have expanded the F reorganization definition in recent years to include fusions of active affiliated companies as long as there is sufficient identity of proprietary interest and there is uninterrupted business continuity. One case treated the merger of 123 affiliated corporations as an F reorganization. The exceptions for F reorganizations from the requirements of existing law closing the taxable year of a transferor corporation and restricting loss carrybacks, are not appropriate to fusions of two or more active business corporations.

3. Bill provisions

Section 302 of the bill would limit the F reorganization definition to a mere change in identity, form, or place of organization of a single corporation.

4. Effective date

Section 302 applies to reorganizations taking place on or after September 1, 1982.