

[JOINT COMMITTEE PRINT]

**FEDERAL INCOME TAX ASPECTS OF
HOSTILE TAKEOVERS AND OTHER
CORPORATE MERGERS AND ACQUISITIONS
(AND S. 420, S. 476, AND S. 632)**

**SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
ON APRIL 22, 1985**

**PREPARED BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION**



APRIL 19, 1985

U.S. GOVERNMENT PRINTING OFFICE

46-217 O

WASHINGTON : 1985

JCS-9-85

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Committee on Finance has scheduled a hearing on April 22, 1985, on Federal income tax aspects of hostile corporate takeovers. This pamphlet,¹ prepared in connection with the hearing, provides a description of many of the Federal income tax considerations relevant to corporate takeovers generally and, therefore, to hostile takeovers as well.

The first part of the pamphlet contains an overview. The second part generally discusses tax policy issues raised by applicable and proposed tax rules. Part three describes the hostile takeover and, in simplified form, common forms of acquisition transactions, and part four contains a more detailed and technical articulation of the tax rules generally applicable. The fifth part describes 3 Senate bills (S. 420 and S. 476, introduced by Senators Boren and Nickles and S. 632, introduced by Senator Chafee) that have been introduced recently relating to tax consequences of hostile takeover activity.

¹This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476, and S. 632)* (JCS-9-85), April 19, 1985.

I. OVERVIEW

The United States is presently in the midst of what appears to be the fourth major merger ² wave since the turn of the century (see Table 1). Like the current merger wave, previous merger booms occurred during strong stock market upswings.³ Merger waves are thought to be related to a variety of economic factors including stock market fluctuations, advances in production and distribution

Table 1.—Mergers and Acquisitions, 1968–84

[Dollar amounts in billions]

Year	Number of transactions ¹	Value of consideration exchanged ²	
		Nominal dollars	Constant (1983) dollars
1968.....	4,462	43.0	112.2
1969.....	6,107	23.7	58.8
1970.....	5,152	16.4	38.6
1971.....	4,608	12.6	28.3
1972.....	4,801	16.7	36.0
1973.....	4,040	16.7	34.0
1974.....	2,861	12.5	23.4
1975.....	2,297	11.8	20.2
1976.....	2,276	20.0	32.5
1977.....	2,224	21.9	33.7
1978.....	2,106	34.2	49.0
1979.....	2,128	43.5	57.3
1980.....	1,889	44.3	53.5
1981.....	2,395	82.6	90.9
1982.....	2,346	53.8	55.9
1983.....	2,533	73.1	73.1
1984.....	2,543	122.2	117.8

¹ Includes only publicly-announced transactions involving transfers of ownership of 10 percent or more of a company's assets or equity, provided that the value of the transaction is at least \$500,000.

² Includes only those transactions for which valuation data are publicly reported.

Source: W.T. Grimm & Company and Council of Economic Advisers.

³ Under the Internal Revenue Code, "merger" is a term of art, referring to certain kinds of combinations of the one corporation with another on a tax-free basis under section 368(a)(1)(A). In this pamphlet, the term generally (except in part four) is used in a non-technical sense to refer to any acquisition or takeover of one corporation by another corporation or other person.

³ F. M. Scherer, *Industrial Market Structure and Economic Performance*, 1970. Scherer identifies merger waves up to 1970; 1887–1904, 1916–1929, and the post-World War II recovery through 1970.

technology, and changing demand conditions. In addition, merger activity is indirectly influenced by the tax system and is directly regulated by the Federal Trade Commission, the Justice Department, the Securities and Exchange Commission, and other agencies.

The current upsurge of merger activity has received considerable publicity because of the unprecedented size of the corporations that have been acquired and the costly and novel defensive and offensive strategies that have been pursued in connection with hostile takeover attempts. Some have expressed concern that the \$122 billion spent on mergers and acquisitions last year diverted corporate resources and management attention away from more productive internal investment opportunities and management responsibilities. Others contend that the threat and conduct of takeovers is socially beneficial because management is forced to maximize the value of corporate assets or risk losing operating control. Still others contend that if large amounts of the nation's wealth are to trade hands through mergers and acquisitions which are at least partly influenced by the tax system, then the tax system should encourage those transactions to be structured in such a way that employees of the affected companies have an opportunity to gain a stock ownership interest. However, one thing is clear: the effect of tax and regulatory policies on the market for corporate control is an issue of significant economic and political consequence. The market value of the securities issued by publicly-traded corporations accounts for over 20 percent of the nation's wealth.⁴

Certain features of the corporate and individual income tax (as well as of the estate and gift tax) may affect the attractiveness of takeovers from the standpoint of both the acquiring and target corporations and their shareholders. The Tax Code may be harmful to economic growth if tax considerations encourage inefficient, or discourage efficient, changes in the ownership of corporations or their assets.

⁴ *Annual Report of the Council of Economic Advisers* (February 1985).

II. TAX POLICY AND THE MARKET FOR CORPORATE CONTROL

The tax Code influences corporate acquisitions directly through rules governing the sale or other disposition of corporate stock or assets and indirectly through the general rules pertaining to the taxation of corporate and individual income and of estates. The interaction of these tax rules may affect the number of acquisitions, the form of an acquisition, the type and amount of consideration paid, the number of taxpayers who may benefit from an acquisition, the tactics used in takeover contests, and the corporations that are candidates for becoming acquirers or targets. The organization of this part is as follows: first, relevant tax rules are summarized; second, the effect of those rules on the form and substance of takeover activity is analyzed; third, the policy implications of tax-motivated or tax-supported takeover activity are assessed; and fourth, some proposals for change in rules applicable to hostile takeovers and hostile takeover attempts are described.

A. Summary of Tax Rules

The Code generally does not distinguish between friendly corporate acquisitions and hostile ones. There are not special Code sections which explicitly apply only in a hostile case or only in a friendly case. With rare exception, therefore, the Code neither encourages nor discourages a hostile, as opposed to a friendly, acquisition.⁵ As a result, to the extent the Code subsidizes corporate acquisitions, it subsidizes hostile ones as well as friendly ones. The general rules must be understood.

Three features of the Federal income tax appear to have the most significant effect on the pattern of takeover activity: (1) the differing tax consequences of acquiring an entire corporation versus acquiring individual corporate assets; (2) the disparate treatment of corporate "distributions" made in the form of interest, dividends, and long-term capital gains; and (3) the inability of corporations with limited taxable income to take full advantage of business tax preferences. These and other aspects of the tax rules are described below.⁶

⁵ Two provisions of the Deficit Reduction Act of 1984 might be viewed as indirectly favoring friendly acquisitions. These are section 246A (denying the dividends received deduction with respect to dividends received on debt-financed portfolio stock) and the new golden parachute rules (secs. 280G and 4999).

⁶ Takeover activity is also influenced by the ability of corporations to obtain financing on favorable terms as, for example, if the financing is structured in such a way that employees gain a stock ownership in their employer corporation through an employee stock ownership plan ("ESOP").

1. General provisions of the corporate income tax

Income from corporate assets that is paid to noncorporate debt-holders is not taxed at the corporate level since interest payments generally are deductible for purposes of computing taxable income. Conversely, corporate income paid out as dividends is subject to corporate-level tax since dividend payments are not deductible by a corporation. Thus, the combined individual and corporate tax on debt-financed investment is no more than 50 percent (the top individual rate), while the combined tax on income distributed from equity-financed corporate investment is as high as 73 percent (assuming a 46-percent corporate rate).⁷ As a result, the after-tax return on a dollar of income on debt-financed assets (50 cents) is, at the highest tax rates, almost double the return on a dollar from equity-financed corporate investment (27 cents). A company with a high debt-to-equity ratio may have a tax advantage over a similar company with little debt financing. Debt-financed takeovers effectively increase the debt-to-equity ratio of the acquired corporation and thus may increase share price to the extent that the tax advantages of debt financing are not outweighed by the disadvantages (e.g., increased bankruptcy risk.)

Under current law, a substantial percentage of the economic income of many corporations escapes corporate income tax as a result of various business tax preferences provided by the Code. Examples of these preferences include the investment tax credit and accelerated depreciation. These preferences cannot be used on a current basis by corporations that do not have sufficient taxable income in the current or prior 3 years. Such corporations can carry forward (up to 15 years) net operating losses and excess credits until current taxable income is sufficient to absorb them.⁸ Companies in a carryforward position are often at a tax disadvantage relative to companies that have sufficient taxable income to use available tax preferences currently.⁹ Thus, there is a tax incentive for structuring mergers which effectively permit more rapid utilization of current preferences and carryforwards.¹⁰

2. General provisions of the individual income tax

Shareholders are taxed on the income from corporate assets only when it is distributed as a dividend or when gain is realized from a sale or other disposition of their shares. Thus, shareholders generally can defer tax on corporate income that is reinvested rather than distributed as a dividend. These rules may lead to large accumulations of undistributed corporate income and attract takeover

⁷ In this case, \$100 of corporate income is subject to \$46 of corporate income tax, and the remaining \$54 of after-tax corporate income is subject to up to \$27 of tax at the shareholder level when distributed. The maximum combined tax is \$73 (\$46 plus \$27).

⁸ A corporation experiencing a real economic loss will likely have NOL and foreign tax credit carryovers even in the absence of tax preferences. However, the prevalence of corporate tax preferences greatly increases the likelihood that even a profitable corporation will be in a carryforward position.

⁹ Corporations may seek to absorb their NOLs by the sale and leaseback of their assets, by recognizing built-in gains, or by other transactions. However, these transactions may be costly or unavailable.

¹⁰ Use of NOLs, excess credits, and built-in losses following an acquisition is limited by Code sections 382, 383, and 269, among others, by the consolidated return regulations.

attempts.¹¹ If reinvestment opportunities are limited, management may decide to use retained income to acquire control of another corporation, lest their own corporation be subject to a similar fate. Alternatively, retained earnings might be used by the corporation to redeem or repurchase its own shares; however, management may prefer to expand the size of the corporation through acquisition rather than shrink it through redemptions of shares.

Individual shareholders are taxed at ordinary income rates, of up to 50 percent, on dividends paid out of corporate earnings. However, individuals are taxed on only 40 percent of long-term capital gains from the sale or other disposition of stock (as a result of the 60 percent long-term capital gain deduction). Consequently, the effective rate of tax on long-term capital gains of individuals is no more than 20 percent. Further, because of the step up in basis of property at death, some gain is not taxed at all. Thus, the Code creates an incentive for corporate transactions and financial policies that produce capital gains, whether currently taxable or deferred, rather than dividends for individual shareholders.

3. General provisions of the estate and gift tax

Federal estate tax generally applies to the transfer of property at death. In general, the estate tax applies equally to transfers of shares in closely- and widely-held corporations, although, in practice, there are differences. First, the valuation of shares in a closely-held corporation is less certain, so the amount of estate tax that will be assessed by the Internal Revenue Service is more difficult to predict. Second, shares in closely-held corporations are less liquid. This may make it difficult for the executors to dispose of stock in order to pay estate taxes and other expenses. These considerations may lead a shareholder in a small corporation to sell his shares or exchange them in a tax-free reorganization for shares in a publicly-traded corporation. However, the Code does contain a number of provisions which mitigate the estate-tax disadvantages of holding shares in closely-held corporations and, as a consequence, reduce the incentive to merge solely for estate tax purposes.¹²

4. Income tax treatment of acquisitions

The Code distinguishes among taxable purchases of corporate stock, taxable purchases of corporate assets, and tax-free reorganizations for income tax purposes (see Table 2). The applicable tax rules have been criticized on the grounds that economically similar acquisition transactions have different Federal tax consequences depending on their legal form.

¹¹ Section 531 (relating to unreasonable accumulations) and other sections seek to limit the excessive accumulation of corporate earnings.

¹² Section 6161(a)(2) provides for an extension of time in the payment of estate tax under certain conditions. See also section 6166. Section 303 provides exchange rather than dividend treatment for redemptions of certain stock included in an estate in an amount up to the amount of estate taxes and administrative expenses. In addition, the Economic Recovery Tax Act of 1981 liberalized the estate and gift tax. See Alan L. Feld, *Tax Policy and Corporate Concentration* (1982), pp. 97-99. The Deficit Reduction Act of 1984 added several provisions to the Code concerning employee stock ownership plans that also reduce the incentive to merge solely for liquidity or estate tax purposes. See section 2210 (payment of estate liability by ESOPs), section 1042 (tax-free rollover on sale of stock to employees), and section 133 (partial exclusion of interest earned on ESOP loans). See also sections 404(a)(9) and 409 (relating to ESOPs).

Control of a corporation's assets can be obtained either by acquiring the assets of the target corporation from the target corporation or by acquiring its stock from the target's shareholders. Generally, the sale of assets by a corporation in a taxable transaction results in the recognition of gain (or loss) to the corporate seller. In addition, the buyer uses its cost for the assets for the purpose of subsequent depreciation, depletion, and amortization deductions and gain or loss computations.

On the other hand, the purchase of a corporation's assets and its subsequent liquidation pursuant to a plan of complete liquidation under section 337 generally does not trigger corporate recognition of gain (although there are exceptions for recapture and similar items) or loss.¹³ Even though gain is not generally recognized to the corporate seller, the purchaser will step up the basis of the assets to their cost. A similar result is obtained by a purchase of shares followed by an actual or deemed section 338 election. If there is such an election, the target generally is treated as having sold its assets in a section 337 transaction and then reacquired them.

Alternatively, the purchase of stock of a corporation may avoid gain recognition (including recapture) by that corporation if a "carryover" transaction is chosen. In a carryover transaction, the acquired corporation retains its tax attributes (such as net operating loss carryovers, credit carryovers, and asset basis). Corporate-level carryover tax treatment is accorded in tax-free reorganizations and in taxable stock acquisitions where a section 338 election is not made or deemed made. Determining whether carryover or step-up tax treatment is more favorable requires considerable analysis, and the acquirer in a taxable stock acquisition frequently will take advantage of the time allowed by section 338(g)(1) before making a section 338 election.¹⁴

Table 2.—Income Tax Treatment of Corporate Acquisitions

Tax consequence	Taxable asset acqui- sition without complete liquida- tion	Taxable stock acqui- sition with sec. 338 election ¹	Taxable stock acquisition without sec. 338 election	Tax-free reorganiza- tion
Corporate income tax				
Recognition of gain/loss	Yes	No	Deferred	Deferred
Recapture	Yes	Yes	Deferred	Deferred
Revaluation of basis..	Yes	Yes	Deferred	Deferred

¹³ Section 337 is an extension of the "codification" of *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935), in section 336. *General Utilities* is often cited for the proposition that, absent a Code section to the contrary, a corporation recognizes no gain or loss when property is distributed to shareholders with respect to their stock.

¹⁴ Under Treas. temp. regs. sec. 5f.338-1(c) (adopted November 17, 1982, and amended February 7, 1984), a section 338 election need not be made before 60 days after publication of the next set of temporary regulations under section 338.

**Table 2.—Income Tax Treatment of Corporate Acquisitions—
Continued**

Tax consequence	Taxable asset acqui- sition without complete liquida- tion	Taxable stock acqui- sition with sec. 338 election ¹	Taxable stock acquisition without sec. 338 election	Tax-free reorganiza- tion
Transfer of NOLs ² ...	No	No	Yes ³	Yes ³
<i>Individual income tax</i>				
Recognition of gain/loss on exchange of shares for:				
1. Cash	N.A.	Yes	Yes	Yes
2. Debt	N.A.	De- ferred	Deferred	Varies
3. Stock	N.A.	Yes	Yes	Deferred

¹ The same tax results generally flow from a liquidating sale under section 337.

² Similar tax treatment applies to credit carryovers and built-in losses.

³ Use of NOL and credit carryovers and built-in losses is limited by sections 382, 383, and 269, among others, and by the consolidated return rules.

The tax consequences of a corporate acquisition at the shareholder level generally hinge on whether the acquisition is structured as a tax-free reorganization and on the type of consideration received. In qualified reorganizations, shareholders of the target corporation are not taxed currently if they exchange their stock for stock in the acquiring corporation.¹⁵ By contrast, in taxable stock acquisitions and liquidating sale transactions, shareholders of the target corporation are generally taxed currently even if they receive stock in exchange for their shares (as if their shares had been sold). (But see sec. 1042.)

Under the installment sale rules, where target corporation shareholders exchange their shares for non-readily tradable term debt of the acquiring company in a tax-free reorganization, taxable stock acquisition, or liquidating sale transaction, the recognition of gain generally may be deferred until principal payments on the note are received (sec. 453). If the transaction is a liquidating sale, or if the acquiring corporation makes a section 338 election in a taxable stock acquisition, then basis in the acquired assets is revalued at the date of election taking into account the principal amount of the note, even though the target's shareholders recognize gain only as principal is amortized. In this manner, the buyer can immediately

¹⁵ The Code provides rules governing 6 generic types of corporate reorganizations which qualify for tax-free treatment: (A) statutory mergers; (B) acquisitions of stock for stock; (C) acquisitions of property for stock; (D) transfers of assets to controlled corporations; (E) recapitalizations; and (F) mere changes in identity, form, or place of organization. (See also section 368(a)(1)(G), which relates to reorganizations involving certain financially-troubled companies).

step up basis while the target corporation wholly escapes tax on gain and its shareholders defer tax on gain.

In summary, the tax treatment of economically similar acquisition transactions depends on the legal form of the transaction. Rather than sell its appreciated property, or distribute its assets or retained earnings directly to shareholders, a corporation may achieve more favorable tax results in a properly-structured acquisition. Thus, the decision to execute a corporate acquisition, and the decision to structure the acquisition in a particular legal form, are both influenced by tax considerations.

B. Effect of Tax Rules on Merger Activity

Although takeovers are often motivated by factors other than tax, Federal tax rules do create a number of opportunities for using takeovers as tax planning devices. In this section, 4 tax planning strategies involving the use of takeovers or mergers are identified: (1) merger as a means of distributing corporate assets ("distributive" merger); (2) merger as a means of churning the tax benefits on depreciable assets ("churning" merger); (3) merger as a means of increasing debt financing ("leveraged" merger); and (4) merger as a means of transferring tax benefits ("tax benefit transfer" merger). In addition, tax barriers to takeover or merger (i.e., situations where the tax rules may inhibit merger) are also discussed.

1. Distributive mergers

The Federal income tax rules generally conform to the principle that earnings and gain are taxed both at the corporate level and the shareholder level to the extent received or accrued. However, in certain types of mergers and acquisitions, it is possible to structure transactions so as to escape, defer, or reduce the rate of taxation at the corporate level and the shareholder level, or both.

The consequences of the tax rules can be illustrated by means of 2 simplified examples involving a corporation with \$100 of retained earnings in the form of cash, in the first case, and \$100 of built-in (unrealized) gain, in the second case. In both cases, the corporation has a \$10 basis in nondepreciable assets (e.g., land) originally purchased for \$10, and there are no deductions or credits that are subject to recapture. In both cases, the market value of the corporate assets is \$110: \$10 of basis plus \$100 of retentions or built-in gain, respectively. The corporation is subject to tax at a 46-percent rate on ordinary income and at a 28-percent rate on long-term capital gain. Shareholders, who have a \$10 total basis in their stock, are subject to tax at a 50 percent rate on ordinary income and at a 20-percent rate on long-term capital gain.

In the first case, the shareholders wish to realize the \$100 of corporate retained earnings (on which the corporation may or may not have paid taxes). If the corporation distributes a \$100 dividend, shareholders will be liable for \$50 of income tax (see Table 3). Alternatively, the shareholders might sell their stock for \$110 in cash to an acquiring corporation in a taxable stock acquisition or have the corporation undertake a liquidating sale under section 337. Either case would result in \$20 of long-term capital gains tax liability for the shareholders on their \$100 in gain, and no corporate tax.

Finally, the shareholders might exchange their shares for \$110 worth of stock in an acquiring corporation pursuant to a qualified reorganization. In that case, the shareholders would take a substituted basis in the stock received from the acquiring corporation and defer tax on their gain (perhaps forever). Thus, as shown in Table 3, the "distribution" of \$100 of corporate income can have tax results ranging from \$20 of deferred tax liability to \$50 of current tax liability, depending on the form of the transaction.

Table 3.—Tax on the Realization of \$100 of Retained Earnings

Tax	Non-liquidating distribution	Taxable stock acquisition with sec. 338 election ¹	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate tax	0	0	0	0
Shareholder tax	\$50.00	\$20.00	\$20.00	² \$20.00
Total tax.....	\$50.00	\$20.00	\$20.00	\$20.00

¹ The same tax results generally flow from a liquidating sale under section 337.

² Tax is deferred until sale of shares and will be fully forgiven if the stockholder dies before disposing of them.

In the second case, the shareholders wish to realize the \$100 appreciation in corporate assets. The corporation could simply sell the appreciated asset and distribute the net after-tax proceeds to the shareholders in an ordinary distribution. If the transaction was not structured as a complete liquidation under section 337,¹⁶ then the appreciation would be taxed at both the corporate and shareholder levels. In that event, the sale would trigger \$28 of corporate tax (assuming the asset was a long-term capital asset or a section 1231 asset), and the distributions would total \$82 (\$110 less \$28), of which \$10 would be a return of basis to the shareholders and \$72 would be a nonliquidating distribution. The shareholders would be liable for \$36 of tax on the nonliquidating distribution, so the total corporate and shareholder tax would be \$64 (see Table 4). Alternatively, if the assets were sold pursuant to a plan of complete liquidation, corporate tax would be escaped (under the *General Utilities* doctrine and sec. 337), and the only tax would be \$20 on the shareholders' \$100 gain. The same tax consequences would flow from a \$110 taxable stock acquisition subject to a section 338 election. However, if a section 338 election were not made, then the acquiring corporation might be willing to pay only \$82¹⁷ for the target's shares, because the acquirer eventually will be liable for \$28 of gains tax when the asset is sold. Under these assumptions, the shareholders would recognize \$72 of gain (\$82 less \$10) and incur

¹⁶ This would be the case if for some reason the \$100 of appreciation were distributed and later, in an unrelated transaction, a \$10 liquidation distribution were made.

¹⁷ Disregarding present value issues.

current tax liability of \$14.40 (.20 times \$72). Finally, the same tax consequences would flow from an exchange of shares worth \$82 in a tax-free reorganization except that the target's shareholders could defer recognition of their gain.

These examples show that the *General Utilities* doctrine, sections 337 and 338, and the tax-free reorganization rules create opportunities whereby shareholders can realize corporate earnings and built-in gains with less than full current taxation at both the corporate and shareholder levels.

Table 4.—Tax on the Realization of \$100 of Appreciation

Tax	Taxable "asset" acquisition		Taxable stock acquisition without sec. 338 election	Tax-free reorganization
	Not liquidated under sec. 337	Taxable stock acquisition with sec. 338 election ¹		
Corporate tax ..	\$28.00	0	² \$28.00	² \$28.00
Shareholder tax	36.00	\$20.00	14.40	³ 14.40
Total tax...	\$64.00	\$20.00	\$42.40	\$42.40

¹ The same results generally would flow from a liquidating sale under section 337.

² Corporate tax is deferred until gain in assets is realized.

³ Shareholder tax is deferred until shares are sold or forgiven if the shareholder dies holding them.

2. Churning mergers

The Code also provides some incentive for mergers designed to minimize tax on corporate assets by churning, i.e., selling property when most of its cost has been recovered through depreciation deductions. In a liquidating sale pursuant to section 337 (or in a taxable stock acquisition with a section 338 election), the buyer steps up the depreciable basis of acquired property to cost and the seller may be subject to recapture tax but not tax on other gain. For example, in the case of section 1250 property, there will in many cases be no recapture tax liability. Thus, if a target corporation that holds fully-depreciated section 1250 property is acquired in a transaction qualifying for step-up treatment, then the buyer will obtain a fresh depreciable basis, often with no tax on the seller. In this manner, the tax benefits of ACRS straight-line depreciation for real property can be magnified by the repeated churning of corporate assets. The benefits of churning can also be obtained by nonliquidating sales of assets. However, the Code favors section 337 and section 338 transactions because they frequently allow the seller to escape tax on gain.

3. Leveraged mergers

The preceding analysis has shown that mergers can be used to distribute assets from corporate solution and to churn the tax bene-

fits of assets. A third tax-advantaged use of mergers is to increase the amount of debt in a target's financial structure ("leverage").

The advantages of debt financing can be illustrated by comparing 2 corporations with \$1,000 of gross assets that are identical except for financial structure: the first is entirely equity financed; while the second is 50 percent debt financed. Both corporations earn \$200 of operating income. The all-equity corporation pays \$92 in corporate tax, leaving \$108 of after-tax income (\$200 less \$92). Thus, as shown in Table 5, the return on equity is 10.8 percent (\$108 divided by \$1,000).

Table 5.—Effect of Debt Financing on Stock Yield

Item	All-equity corporation	50-percent debt-financed corporation
Balance sheet		
Total assets	\$1,000.00	\$1,000.00
Debt.....	0	500.00
Shareholders' equity	1,000.00	500.00
Income statement		
Operating income	200.00	200.00
Interest expense.....	0	70.00
Taxable income.....	200.00	130.00
Income tax	92.00	59.80
Income after corporate tax	108.00	70.20
Return on equity ¹ (percent).....	10.8	14.04

¹ Return on equity is computed as income after corporate tax divided by shareholders' equity.

As indicated, the leveraged corporation is financed by \$500 of debt and \$500 of stock. If the interest rate on the debt is 14 percent, then interest expense is \$70 (.14 times \$500). Taxable income is \$130 after deducting interest expense. The leveraged corporation is liable for \$59.80 in corporate tax (.46 times \$130), leaving \$70.20 of after-tax income (\$130 less \$59.80). Consequently, the return on equity is 14.04 percent (\$70.20 divided by \$500.00). Thus, as shown in Table 5, increasing the debt ratio from zero to 50 percent increases the rate of return on equity from 10.8 to 14.04 percent.¹⁸

In summary, the Code encourages leveraged acquisitions to the extent that the managers of target corporations fail to exploit fully the tax advantages of debt financing. This may occur where existing management is more financially conservative than a potential acquirer. The Code also encourages the use of debt as payment in exchange for target stock because shareholders may use the installment method of reporting to defer capital gains tax. Finally, the Code encourages "leveraged" acquisitions to the extent that the debt is repaid through the financing technique of an employee stock ownership plan. Under this technique, the acquisition lever-

¹⁸ More generally, the return on equity rises with increasing debt capitalization so long as the interest rate on the debt is less than the pre-tax rate of return on corporate assets.

age results in the creation of an equity interest for employees of the affected company.

4. Tax benefit transfer mergers

Generally, the Code prohibits the direct sale of tax benefits from one corporation to another, requiring instead that tax benefits reduce the tax liability of the corporation that generated the benefit. For example, deductions for net operating and built-in losses cannot be sold. Nor can excess tax credits. However, in certain circumstances, tax benefits can be acquired indirectly by means of a properly-structured merger. Section 269 seeks to discourage mergers designed principally for tax purposes. In addition, sections 382 and 383 and the consolidated return rules generally seek to prevent buyers from using the target's tax benefits to reduce tax liability from unrelated assets. Nevertheless, there are a number of techniques which may allow an acquiring corporation to use a target's tax benefits more rapidly than the target.¹⁹

5. Other tax-motivated mergers

The preceding analysis has concentrated on the use of mergers in executing tax planning strategies designed to distribute corporate income, churn tax benefits, increase debt financing, and transfer tax benefits. Tax-motivated mergers may also occur in other situations. For example, tax-free reorganizations are a useful device in estate-tax planning for avoiding the illiquidity and valuation problems associated with stock in a closely-held corporation.

The liquidity available through a tax-free reorganization may also be available to a taxpayer if the corporation in which the taxpayer owns stock establishes an employee stock ownership plan to which the taxpayer sells his stock and "rolls over" the gain tax-free into other, more liquid securities under section 1042. In this case, Code section 1042 reduces the incentive to undertake a tax-free merger solely for purposes of creating a more liquid investment.

6. Tax barriers to merger

While there are many cases in which the Code appears to encourage mergers, there are also instances where the Code inhibits the combination of assets. The Code serves as a barrier to takeover where shareholders in a potential target hold stock with substantial appreciation and the takeover is not structured as a tax-free reorganization. In this case, the exchange of stock in the target for cash or stock in the acquiring corporation generally will trigger tax on the gain built into the target stock. An otherwise economically efficient combination of assets might not take place because of adverse tax consequences. Thus, the Code may contribute to economic inefficiency not only by encouraging inefficient mergers but also by discouraging efficient ones.

¹⁹ For example, a company with net operating losses can acquire a profitable company and use its losses to reduce the target's tax liability. Similarly, a profitable company may acquire a target's NOLs in a qualified stock reorganization and subsequently transfer some of its income-generating assets to the target in an attempt to avoid the consolidated return rules.

C. Policy Implications of Tax-Motivated Merger Activity

The principal tax policy issues raised by tax-motivated or tax-supported takeovers or mergers appear to be: (1) whether the effect of the tax Code on the volume and type of merger activity is harmful; and (2) whether the tax Code should be used to encourage or discourage certain types of mergers or merger tactics. A related issue is whether the tax Code should include incentives to broaden the class of taxpayers whose capital ownership interests are enhanced by mergers and acquisitions to include the employees of corporations involved in such transactions.

Although there is little conclusive evidence, a number of experts have concluded that the Code has tended to increase the volume of merger activity. In one study, tax considerations were found to be the major reason for over one-fourth of the mergers during the period 1940-47.²⁰ This finding may be cause for concern because from the standpoint of economic efficiency, mergers undertaken for tax reasons may not be justified.

Some have argued that the efficiency gains from the current merger wave are likely to be large based on studies showing that stock prices increase substantially after merger.²¹ However, it is possible that a large portion of the stock price gain is in fact due to the capitalization of tax benefits arising from the merger. Obviously, if tax benefits explain the increase in stock price, then it cannot be concluded, from this evidence alone, that mergers increase efficiency. Also, the stock market gains associated with mergers appear to be ephemeral—disappearing altogether in the year after acquisition.²²

While acknowledging that the economy would be better off without certain tax-motivated mergers, it has been argued that mergers used as a means of selling tax attributes, such as net operating losses and excess credits, may be beneficial.²³ The argument is that entrepreneurs are more willing to undertake risky investments knowing that in the event of failure, some portion of loss and credit carryovers can be sold in a merger. However, after an investment has failed, there is generally no efficiency rationale for mergers designed to traffic in losses. Furthermore, the use of mergers to transfer tax benefits is a cumbersome and costly approach.

Others contend that, in the absence of evidence demonstrating that mergers are generally beneficial to the economy, tax policy should be "neutral" with respect to mergers and acquisitions. Mergers would in this case be based more on efficiency considerations (provided that antitrust enforcement is effective in preventing mergers that would create monopoly power) and more likely to increase productivity. However, in altering the tax Code to remove incentives for merger or takeover, caution would need to be exercised in order to avoid creating excessive tax barriers. For example,

²⁰ J. Keith Butters, John Lintner, and William L. Cary, "Effects of Taxation: Corporate Mergers", Harvard Business School (1951).

²¹ See *Annual Report of the Council of Economic Advisers* (February 1985), Chapter 6. These studies compare the market value of the resulting company with the pre-merger value of both the acquirer and the target.

²² See Warren A. Law, "Testimony before the House Committee on Energy and Commerce Subcommittee on Telecommunications, Consumer Protection, and Finance" (March 12, 1985).

²³ *Annual Report of the Council of Economic Advisers* (February 1985).

forcing recognition of gain in certain corporate acquisitions could result in a "lock-in" effect: sale of corporate assets to superior management might be discouraged by the triggering of adverse tax results.

In addition to being concerned about the high volume of merger activity in recent years, some believe that offensive and defensive tactics employed in takeover contests are harmful to shareholder interests and public policy goals. Bidders have been criticized for, among other things, the use of "2-tier" offers and the issuance of sub-investment grade ("junk") bonds, while defenders have been accused of using abusive tactics such as limited share repurchases ("greenmail") and lavish severance contracts triggered by takeover ("golden parachutes"). Those who believe mergers are disruptive, inefficient, or monopolistic tend to oppose the aggressive tactics used by bidders, while those who believe that mergers promote competition and efficient utilization of resources are more worried about tactics used to ward off a hostile takeover.

The tax Code appears neither to directly encourage nor discourage such techniques as the use of 2-tier offers or greenmail in hostile takeover attempts. However, by generally allowing interest to be deducted, the tax Code reduces the after-tax cost of beginning a hostile takeover attempt with borrowed funds. The Code also encourages debt-financed mergers as a result of the general tax advantages available to the debt financing of corporations and the installment method of reporting gain on shares exchanged for debt. While section 279 seeks to discourage mergers financed by convertible subordinated debentures and similar instruments, the scope of this provision is narrow. Finally, the attractiveness of golden parachutes was reduced by the Deficit Reduction Act of 1984.

While the harmfulness of certain takeover tactics is a controversial issue, there are a number of possible remedies other than tax Code amendments. If it deemed it proper, Congress could amend the securities laws to regulate certain takeover tactics. In addition, shareholders can amend corporate charters to prevent management from engaging in defensive tactics that might reduce their chance to benefit from a generous tender offer. Shareholders can also challenge defensive strategies that are not in their interest through the courts.

D. Proposals for Change

Tax-motivated or tax-supported takeovers and hostile takeover attempts result from both the general rules of the Code regarding the measurement of income from capital as well as specific provisions regarding the taxation of acquisitions. A full range of proposals for change would address the root causes of tax-motivated or tax-supported mergers and acquisitions including: (1) the double tax regime; (2) the deductibility of interest; (3) business tax preferences; and (4) net operating losses and other tax attributes.

Much more narrowly, 3 Senate bills recently have been introduced (see part five) which relate only to "hostile" acquisitions. These would deny interest deductions on a broad class of debt (or all debt) incurred to finance the hostile acquisition of corporate stock or assets and impose tax penalties on payments of greenmail

and other transactions. Some of these bills treat every hostile qualified stock purchase as a sale of assets by the target corporation in a transaction not protected by section 337.

Because these narrow proposals address the most glaring symptoms of the current merger boom but not a number of the root causes of tax-motivated mergers, they raise the question of whether tax-motivated or tax-supported merger activity would be reduced or, instead, alternative strategies devised for completing corporate acquisitions. For example, any junk bond rule might be fairly easily avoided. Thus, if a junk bond were defined as a bond rated at least 2 ratings below a standard, a bond rated only one rating below that standard (or not related at all) would not be a junk bond. However, to the extent any such proposal was enacted and effective, it is likely that fewer hostile takeover attempts would be commenced. Such a state of affairs might permit management of former potential target corporations to go about their business with less disruption and might have the salutary effect of reducing the benefits provided by the tax law for highly-leveraged capital structures. It might also prevent the consummation of many economically desirable corporate acquisitions. And it would tend to reduce acquisition premiums now being paid to target shareholders.

III. CORPORATE TAKEOVERS: HOW THEY OFTEN WORK

A. Hostile Takeovers

The term "hostile takeover" may be, in one significant sense, a misnomer. While there have been some exceptions, most acquisitions of publicly-held corporations that have actually occurred in recent years have ultimately been friendly ones. That is, management of the target corporation has not formally opposed or resisted the particular acquisition transaction that finally took place. However, several recent acquisitions were preceded by real or apparent acquisition attempts or threats that were resisted by management of the target corporation. Furthermore, in many of those cases, it is likely, or possible, that had no unwelcome takeover attempt been made or threatened, no ultimately friendly acquisition would have occurred. Thus, to the extent the laws (tax, securities, or other laws) encourage the commencement of hostile takeover attempts, those laws may be to some extent responsible for many of the "friendly" takeovers that have occurred.

It is often said that much of the recent corporate takeover activity is attributable to the fact that, in the case of many corporations, stock prices over the New York Stock Exchange and other exchanges do not adequately reflect the value of their underlying net assets.²⁴ Thus, much takeover activity commences when a potential acquiring corporation or group identifies a corporation the stock of which seems to be trading at amounts well below underlying net asset value. That corporation will be an attractive target, particularly if it does not have a few very large shareholders.

The fact that ownership interests in a corporation are represented by stock and the fact that, in the case of public companies, stock is readily obtainable over the stock exchanges make the initial steps of a hostile takeover attempt relatively simple. The potential acquiring corporation or group will easily acquire, frequently with borrowed money, up to 5 percent of the target's outstanding stock. The acquisition of up to 5 percent of the target's stock usually can be done anonymously. As a result, those purchases may in theory be made without significantly affecting the stock exchange price for the target's stock. Thus, the would-be acquirer cannot only commence a takeover but it can commence it at what it views as a depressed price. If the acquirer is correct in its belief that its initial stock purchase has been at bargain price, it will make a substan-

²⁴ For those concerned with takeover activity, one of the most important questions to ask is why stock market prices are low in comparison to underlying asset value. The tax-writing committees may ask whether the Federal tax laws provide at least some of the answer. Many attribute at least some of the value differential to the double tax system. Thus, for example, assume that a corporation pays significant Federal income taxes. In theory, those payments will reduce the corporation's after-tax cash flow and, therefore, the capitalized value of that cash flow. If an acquirer can reduce or eliminate the target's tax liability, without expending extra cash, the target's cash flow, and, therefore, the value of that cash flow, will increase.

tial profit—even if it acquires no more target stock—so long as somebody completes an acquisition of the target. While the character of any such profit may be an open question in some cases, presumably most taxpayers report it as capital gain.²⁵ Thus, subject to section 163(d) (relating to limitations on the deductibility by taxpayers other than corporations of interest on investment indebtedness) and other sections, the acquirers will generally deduct against ordinary income interest on indebtedness incurred to purchase stock that generates tax-favored long-term capital gain.

Once the would-be acquirers have acquired 5 percent of a target's stock, they are generally required to make a filing with the Securities and Exchange Commission under the Williams Act (amending section 13(d) of the Securities and Exchange Act of 1934). The Williams Act filing is a public disclosure document. In it, the acquirers of the 5 percent are required to disclose, among other things, their current holdings in the target and their future plans with respect to the target. Thus, for example, the filing may disclose that the acquirers plan to attempt to acquire the target on stated terms. The filing is to be updated as appropriate.

In general, the first Williams Act filing is not required until 10 days have passed since the acquirers first achieved a 5-percent position. Thus, the acquirers may be able in that 10-day period to increase their holding in the target anonymously, i.e., at pre-existing "bargain" prices. However, once a Williams Act filing has been made (and often before that), the "market" will realize that a takeover or attempted takeover may be imminent, and the stock market price of the target company can be expected to rise dramatically. This is especially true if the acquirers disclose in their Williams Act filing a plan to acquire the target at a stated figure. In such a case, the market price will tend to rise to within a few points of the stated figure (and sometimes above the stated figure, if the market anticipates that a better offer will be made).

While generalities can be dangerous, at this point many of the target's public shareholders will sell their stock in order to realize the substantial gain resulting from the market's newly-formed expectation that a takeover will occur. The buyers will tend to be "risk arbitrageurs". The risk arbitrageur's objective is generally to earn a profit of a few points per share based on the difference between the ultimate takeover price and the market price for the stock after it is known that a takeover attempt is imminent. A primary risk that the risk arbitrageur takes is that no takeover will occur and that the market price for the stock involved will then revert to its previously depressed level. If that occurs, as it does from time-to-time, the risk arbitrageur usually may lose a substantial sum of money.

²⁵ Furthermore, by the use of pre-existing shell corporations, the acquirers may be able to turn what would otherwise have been short-term capital gain into long-term capital gain. The technique involves using a shell corporation that has been held long-term by the acquirers. The shell corporation buys the target stock. If the target stock is to be sold before it has been held long-term, the acquirers simply sell the stock of the shell corporation instead. Given the provision in the Deficit Reduction Act of 1984 reducing from more than one year to more than 6 months the holding period requirement for long-term capital gain treatment, such a technique may be less necessary than it was prior to the Act.

What is significant about the risk arbitrageur's activity? The risk arbitrageur has become a stockholder primarily to earn a modest, short-term percentage profit on his investment. He is not an historic shareholder and may evaluate a proposed takeover offer differently than an historic shareholder would. Perhaps more importantly, the risk arbitrageur has a substantial interest in seeing that a takeover is consummated, for he may suffer greatly if that does not happen and the stock price drops back to its pre-takeover attempt level. Thus, the target corporation at this point may be owned to a large extent by persons whose main interest is in seeing that a takeover occurs. This is why it is thought by many that once a takeover attempt has started with respect to a target, a takeover of the target will likely occur, if not by the persons who started it, then by somebody else.

Once it is evident that the original acquirers are planning or threatening a takeover attempt of the target, the target management, usually acting through the target's board of directors, can be expected to react. In some cases, management may support the attempt and the related offer. In other cases, management may generally support the attempt but seek a better price. In many instances, however, management is likely to oppose the attempt. It is primarily this last case that introduces the term "hostility" into the corporate takeover lexicon.

There is no single reason why management may be opposed to a particular takeover attempt although frequently it is claimed that the proposed offer is "inadequate". If they are opposed, a number of things may happen. For example, management may try to stop the attempt on legal (e.g., securities or antitrust) grounds. Management may take steps to make the target less attractive to the potential acquirers (e.g., by selling important corporate assets, adopting "poison-pill" tactics, or persuading shareholders to adopt other defensive amendments to the corporation's articles of incorporation).²⁶ Or the target corporation may buy back any target stock the acquirers may have already accumulated at a premium price ("greenmail") in exchange for an agreement on the part of the acquirers not to commence a new takeover attempt for a period of years (a "stand-still" agreement). Perhaps such a buy-back will be a part of a broader transaction (e.g., a recapitalization and redemption or a leveraged buy-out). Finally, the target may search for a "white knight", a person or group of persons acceptable to management which is willing to buy the company on terms management does not oppose. Sometimes, management itself will be the white knight and buy the company in a "going private" transaction. If a white knight is found, target shareholders will tend to be content. Public shareholders will profit, whether they sold to risk arbitrageurs or to the white knight. The risk arbitrageurs will profit to the extent of the few points a share. And the original acquirers will make a large profit because much of their target stock was bought at the historic bargain price.

²⁶ Many companies that view themselves as possible takeover targets take steps to make themselves unattractive before any particular takeover attempt has been started or threatened so that no such attempt will be made.

Recent years have seen the advent of the so-called "2-tier" offer. Even white knights have been known to use the 2-tier offer. In the 2-tier offer, the white knight (or other buyer) will announce plans to acquire part of the target for one price or on one set of terms and the balance for another price or on another set of terms. The price or terms for the first part will be more generous to shareholders than the price or terms for the second part. For example, the buyer, expecting to use borrowed funds, may make a tender offer for 60 percent of the target's stock at \$60 in cash per share and announce that it will thereafter buy the remaining 40 percent at \$55 in cash per share (or \$55 in long-term installment obligations). Frequently the second step is carried out, after the first step has been completed (and the buyer has obtained control of the target), by means of a "squeeze-out" or "cram down" merger between the target and the buyer (or an affiliate of the buyer). The significant advantage to the buyer of the squeeze-out merger is that upon its completion, the buyer will own 100 percent of the target by reason of the operation of most State merger laws. That is, there will be no target minority shareholders. As a corollary, all former target shareholders will end up having made an exchange. If the transaction is not part of a tax-free reorganization,²⁷ those shareholders would end up having a taxable event, regardless of whether their participation was voluntary or involuntary.

The 2-tier offer provides significant advantages to a buyer. First, by offering a better price to those target shareholders who sell first, it is generally thought that persons who might not otherwise have sold their stock to the buyer will wish to do so, fearing that if they do not, they will end up having to sell in connection with the less favorable second step, the squeeze out merger. Second, it is obviously to a buyer's advantage to pay \$60 per share for 60 percent and \$55 per share for 40 percent, rather than \$60 per share for 100 percent. And third, the 2-tier offer may permit the buyers to more easily finance the acquisition. For example, a buyer (for tax or for other reasons) may be able to get better financing terms from selling shareholders in an installment obligation squeeze-out merger than from a bank, insurance company, or other lender.

The above discussion obviously is not limited to a discussion of how tax considerations influence hostile takeover attempts. However, to the extent tax-law changes may be appropriate, they should not be considered in a vacuum.

B. The Acquisition Transaction Simplified: The Federal Income Tax Perspective

This section describes the tax profiles of various potential acquired corporations and various potential acquiring corporations or

²⁷ An acquisition cannot be a tax-free reorganization unless an acquiring corporation issues at least some of its (or a parent's) stock in the transaction. Most recent acquisitions of publicly-held companies have not been done as tax-free reorganizations. There are many reasons for this. One is that corporations are reluctant to issue common stock when the market price for that stock is low: issuing stock at such a time substantially dilutes the interests of the acquiring corporation's own shareholders. Another reason may be that, in the current takeover surge, stock of an acquiring corporation (rather than cash) is not psychologically satisfactory to the selling shareholders. A third reason is that many recent acquisitions have been "going private" transactions. Finally, section 338 elections are not available with respect to tax-free reorganizations.

groups. It then indicates particular acquisition transactions that would appear to be the most beneficial to the parties from a Federal income tax standpoint under present Code rules. Under the circumstances, hostility between the potential acquirer and management of the target may or may not be present.

The objective of this part is to inform the reader who is not an expert in the intricacies of subchapter C of the Code of (1) some of the tax benefits available in an acquisitions context, and (2) techniques authorized by the Code to obtain those benefits. Therefore, the cases described (which are not all-inclusive) are simplified cases, designed more to present general principles than to identify actual transactions. Part four contains a more technical exposition of many of the tax rules involved.

It is not intended to suggest that factors other than tax factors play no role in determining whether an acquisition is undertaken and, if so, in what form. Business, antitrust, regulatory, financial reporting, and other legal and personal concerns, among other considerations, are frequently as important, if not much more important, than tax matters. On the other hand, it is clear that tax considerations are very relevant in many acquisitions. Furthermore, if they are not the primary reason for an acquisition, they frequently provide some "gravy" or affect the price at which it is carried out.

One additional preliminary comment: section 269 of the Code deals with certain acquisitions the principal purpose of which is the evasion or avoidance of Federal income tax. Where 269 applies, the general effect is to prohibit the evasion or avoidance aimed at. In what follows, it is assumed in every case, without inference, that section 269 would not be applicable.

Case (1): Redemptions (share repurchases) with borrowed funds

Corporation M is a widely-held public company with little outstanding debt. It pays and has paid substantial taxes but still throws off significant cash flow. It may or may not pay large dividends to its shareholders.

From a tax standpoint, M should seriously consider borrowing a large sum of money and using the proceeds to redeem M stock held by some of its shareholders. There would be 2 significant tax advantages to such a strategy that would not be available under a "business-as-usual" approach.

First, the transaction generally could be structured so that any gain of the redeemed shareholders attributable to the distribution would be capital gain. In contrast, periodic distributions made by M to its shareholders would generally be fully taxed to them at ordinary income rates as dividends.

Second, M could deduct the interest it pays or accrues on the borrowed funds. This would enable M to reduce its taxable income, perhaps to an amount approximating zero (or even generate current tax losses which it could carry back to obtain tax refunds). If so, its Federal income tax liability would go down, and its cash flow could increase significantly. That increased cash flow might be sufficient to enable M to cover most of its debt service obligations with respect to the borrowed funds and retire much of the debt over a period of years (although M might also have to sell some of its assets to raise cash to assist it to pay off the loan). In substance,

non-redeemed (i.e., continuing) shareholders would have acquired the stock of the redeemed shareholders substantially with pre-tax income. In contrast, had M not borrowed money to do the redemption, but used its own funds, the redemption would have been financed by M with after-tax income.

Thus, assume that M has 10 shares outstanding valued on the New York Stock Exchange at \$100 each for a total of \$1,000. The corporation has no debt, and its taxable income is \$200. At a 46 percent tax rate, it pays taxes of \$92.00, leaving it with a cash flow of \$108.00. This is \$10.80, or 10.8 percent, per share. It may or may not use all or part of that \$108.00 to pay dividends to its shareholders.

Suppose M borrows \$500 at 14 percent interest and uses the proceeds to redeem one-half (5) of its shares. After this transaction, it will have taxable income of \$200 less \$70 (interest expense), or \$130. At a 46 percent tax rate, it will pay \$59.80 in taxes, leaving it with a cash flow (before paying back any principal on the loan) of \$70.20. That is \$16.20 more than the pre-redemption 10.8 percent times the 5 shares still outstanding (\$70.20 less \$54.00). By servicing part of its capital with tax deductible amounts, the corporation will have increased its per share cash flow and, therefore, its per share value.

Case (2): Leveraged buy-out

If M does not proceed as suggested in Case (1) or a similar fashion, others may be willing to provide "assistance". Thus, a group of wealthy individuals, including some M management, may want to buy M in a "leveraged buy-out". They are prepared to contribute 20 percent of the purchase price as equity and have made arrangements to borrow the remaining 80 percent. The buying group will use Corporation MM, a newly-created company, as the acquiring vehicle. MM will buy all the stock of M in a taxable transaction (perhaps in part through a squeeze-out merger). Immediately after the acquisition, M will merge into MM. The lenders in the transaction will lend the 80 percent to MM on terms reflecting the degree of leverage and the loan security involved. (The market-place may characterize the debt as "junk" bonds.) The lenders in the transaction will lend the 80 percent to MM. Immediately after MM's merger into M, the loan will be secured by mortgages on and pledges of M's former assets now held by MM. Because of the interest deductions generated by the borrowing, MM, after the merger, may have little, if any, taxable income (and may have loss carrybacks). As a result, MM may be able to service its debt obligations out of a cash flow not reduced (or reduced less) by taxes. The buyers hope and expect that the loan (principal and interest) can be mostly paid off after several years out of that cash flow of MM. If so, M would have been acquired largely with its own pre-tax income.

Case (3): Change in shareholder investment without current tax; step up at death

Corporation A's assets have a value approximating their tax basis. A, an operating service company, has no significant net operating loss carryovers or other tax attributes. A has a single share-

holder, individual X. X, age 75, has a very low basis in his A stock. Corporation B wants to acquire A.

From a tax standpoint, the sensible deal would be for B to buy A's assets for cash (perhaps raised through borrowing) or for B and A to combine in a tax-free reorganization (with X receiving B stock in exchange for his A stock). If B bought A's assets for cash and X kept A alive as a personal holding company, A would pay minimal tax and X would pay none. Through this personal holding company, X could then make portfolio stock investments and receive (after A paid taxes on its investment income) close to a market-rate return on an amount equal to the value of A. Thus, X would have significantly changed the nature of his holding, from an operating service company to a portfolio investment company, without being currently taxed on the gain in his stock. (Furthermore, after X's death, his heirs would inherit his A stock and take a fair market value basis in it under section 1014. As a result, the appreciation in value of the A stock in X's hand might go untaxed forever.)

If B and A did a tax-free reorganization, with X receiving B stock, neither A nor X would be taxed. (Again, upon X's death, his heirs would take a fair market value basis in his B stock, and no tax would ever have been imposed on the appreciation in X's stock.)

Alternatively, X may be able to sell his A stock to an employee stock ownership plan established by A and "roll over" the proceeds tax-free by investing them in securities of other operating corporations, thereby changing the nature of his holding from an operating service company to a portfolio of diversified securities, by putting in place a financing technique (the ESOP) permitting the acquisition of his stock for the employees of A. The basis of X in his A stock would be carried over to his new investments. See Case (14).

If, instead, B bought the A assets and A was then liquidated, or if B bought the stock of A from X, X could use the liquidation or sales proceeds to invest in portfolio stocks. In either such case, however, X would be taxed on the appreciation in the value of his A stock, leaving him with a smaller capital investment.

Case (4): Step up in basis with no corporate tax; tax-exempt shareholders

Corporation C's assets have a very low basis relative to their value. However, they have no depreciation or other recapture potential. C has no significant net operating loss carryovers or other tax attributes. C's sole shareholder, individual Y, has a basis in his C stock approximating its value. Corporation D wants to acquire C.

From a tax standpoint, a sensible deal would be for D to buy C's assets for cash (perhaps raised through borrowing). If D buys C's assets, C should liquidate under section 337. Alternatively, D could buy all Y's stock in C and make a section 338 election. (If D makes a section 338 election, the transaction would generally be treated by C as a sale of assets followed by a prompt liquidation under section 337.) In either case, Y would have only nominal tax liability, and C, under section 337, would have no tax liability at all with respect to the appreciation in value of its assets. Furthermore, D would take a "stepped-up" tax basis in C's old assets equal to their

cost (and thus, for example, generally could begin depreciating them immediately under ACRS to the extent they were depreciable property). As a result, the appreciation in the value of C's assets would never be taxed to any corporation. In contrast, if there were no acquisition of C, C generally in the normal course of its business would pay tax on the appreciation in the value of its assets, and any distributions it made to Y generally would be taxed to Y as dividend income.²⁸

If the parties did a tax-free reorganization, neither C nor Y would have any immediate tax liability, but D would inherit C's low asset basis and depreciation methods.

Case (5): Deferral of shareholder gain with installment sale

The facts are the same as in Case (4) except that individual Y has a low basis in his C stock. If a tax-free reorganization is done, nobody will pay any current taxes, but D will not get to step up the basis of C's assets. But if a cash transaction under section 337 or 338 is done, Y will have a large current tax liability. An alternative would be to have D issue its non-readily tradable term installment obligations, bearing a market rate of interest, for the C assets or stock (followed by a section 338 election). Under that approach, D would get an immediately usable basis in C's assets in an amount equal to their cost (as well as annual interest deductions), and C would have no significant tax liability. Furthermore, Y, under section 453, could generally defer paying taxes on the appreciation in the value of his C stock until D made principal payments on the installment obligations. Meanwhile, Y would be getting from D market-rate interest on the entire principal amount of the obligations (i.e., the sales price). If the consideration to Y had been cash, Y could have invested at market rates only that amount less the amount of tax currently due on his gain. In effect, using section 453 would permit Y to obtain an interest-free loan from the Federal government.

Case (6): Avoiding recapture

Corporation E is a widely-held public corporation. Its assets have a tax basis which is low relative to their value. However, most of that difference would be treated as depreciation recapture (or similar items) were E to sell its assets for their value. Neither E nor Corporation F has any significant net operating loss carryovers. F wants to acquire E.

It would not make tax sense for F to acquire E's assets in a taxable transaction or for F to acquire E's stock in a taxable transaction and make a section 338 election. In either case, F would get a step up in basis for E's assets. However, E would have immediate ordinary (recapture) income in an amount approximating that stepup. The tax cost of that ordinary income would exceed the present value of the basis step up for the E assets. Therefore, F

²⁸ Suppose, instead, that C's sole shareholder in Case (4) is a tax-exempt organization or a foreign person who is not a U.S. taxpayer. (Much publicly-held corporate stock in this country is held by tax-exempt organizations.) Suppose further that shareholder has a low basis in its C stock. Under these facts, C could sell its assets and liquidate under section 337, or D could buy the C stock for cash and make a section 338 election. In either event, generally neither C nor its shareholder would have any U.S. tax to pay under present law.

should consider buying the stock of E and not making a section 338 election (in which case the basis of E's assets would not change and E would have no taxable income, but the E shareholders would be taxed) or doing a tax-free reorganization with E. If such a reorganization were done, again the basis of E's assets would not change, but E's shareholders would generally have a tax-free transaction.

Case (7): Use of acquirer's NOLs

The facts are the same as in Case (6) except that F (but not E) has large net operating loss carryovers that it does not expect to be able to use in the normal course of its own operations. In this case, F should consider buying all the E stock in a taxable transaction and not making a section 338 election, in which case there would be no change in the basis of E's assets. Thereafter, F could sell some or all of the E assets for their value. Assuming F and E are filing consolidated returns, F's net operating loss carryover could be used to offset the gain to E on the sale of its assets. E could then reinvest the sales proceeds in new assets, which may or may not be similar in function to the assets sold. As a result, the new E assets would get a new basis, and no corporate tax would ever be paid on the recapture income inherent in the old E assets (although E's shareholders would be taxed). Alternatively, the parties could do a tax-free reorganization to the same end. In that case, E's shareholders would generally have a tax-free transaction.

Case (8): Target built-in loss

Corporation G is a widely-held public company. Its assets have a tax basis which is very high relative to their value (i.e., there is "built-in loss"), and it is not currently paying taxes. Corporation H, which is very profitable and pays substantial taxes, wants to acquire G.

H should not buy G's assets in a taxable transaction or buy the G stock in a taxable transaction and make a section 338 election. In either case, the basis of G's assets would be reduced ("stepped down") to their cost, and the benefits of G's built-in loss would disappear. Rather, H should consider buying G's stock in a taxable transaction and not making a section 338 election. In that case, while G's shareholders would be taxed, there would be no change in the tax basis of G's assets. Assuming G and H file a consolidated return after the acquisition, H, subject to several limitations, would be able to make use of G's built-in loss through depreciation deductions or sales of G assets. Thus, H could receive tax benefits based on an amount substantially in excess of what it paid for the G stock. This differs from general Code principles, under which tax benefits are usually based on cost to the taxpayer.

Alternatively, G and H could combine in a tax-free reorganization, with similar results. Furthermore, in that case, G's shareholders would generally not be taxed currently.

Case (9): Acquisition by a loss corporation

Corporation I is a very profitable corporation which pays significant taxes. Its assets have a tax basis approximating their fair market value. Corporation J has net operating loss carryovers. J wants to acquire I.

J has substantial tax-planning flexibility. It could acquire the I assets in a taxable transaction, it could acquire the I stock in a taxable transaction, or it could acquire I in a tax-free reorganization. In any such case, J would be putting itself into a position where it could deduct from future taxable income generated by I (or the former I assets) its own net operating loss carryovers from periods preceding the acquisition.

Case (10): Acquisition of NOLs

The facts are the same as in Case (9) except that I has significant net operating loss carryovers, and J pays substantial taxes. J should not buy I's assets in a taxable transaction or buy the I stock in a taxable transaction and make a section 338 election. If it did, I's net operating loss carryovers would not be available to it. Under almost any other acquisition form, J could acquire I, including its net operating loss carryovers. Subject to some limitations, J could then use I's pre-acquisition carryovers to offset its own (or I's) post-acquisition taxable income.

Case (11): Liquidating sales to different buyers

Corporation Q is a widely-held holding company. Its assets consist of all the stock of each of 10 operating companies, none of which is held as inventory. Q's aggregate basis in that stock is well below the aggregate value. An investor group wants to acquire Q for cash. It creates newly-formed corporation P, and P buys all the stock of Q. P does not make a section 338 election. After the purchase, P causes Q to make liquidating sales of the stock of each of its 10 subsidiaries, for cash, to 10 unrelated corporate buyers, each buyer buying one subsidiary. Q and P both then liquidate, the investor group ending up with the cash received by Q on the separate sales of its subsidiaries.

Under this transaction, generally P and Q would not be taxed, despite the appreciation in value of Q's holdings. The investor group would be taxed on any gain, probably at long-term capital gains rates (as would shareholders of Q who sold their stock to P). Each of the 10 different buyers would be able to make an independent judgment as to the wisdom of a section 338 election with respect to the stock of the subsidiary it just acquired. Some probably would make an election, and some would not.

These results could also have been achieved by Q alone, without P's (or the investor group's) participation.

Case (12): Overfunded pension plan

Corporation K is a widely-held public corporation. K maintains a defined benefit pension plan established for the exclusive benefit of its employees. The plan is a qualified plan under section 401, and the related trust qualifies for tax exemption. The trust is currently overfunded by approximately \$100 million on a termination basis. That is, if the trust were currently to be terminated, its assets would exceed the present value of the benefits accrued under the plan by K employees up to the date of plan termination. Corporation L wants to acquire K.

Under almost any form of acquisition, L, subject to some limitations, could cause K to terminate its pension plan. The termination

would enable L, directly or indirectly, to obtain the \$100 million. It could be used to assist L in paying for the acquisition, for general corporate purposes, or for any other purpose. While the \$100 million would be included in the gross income of K (or L) upon termination of the plan, any net operating losses and loss carryovers of L (or K, depending on the acquisition form) could be used to offset that income.

If K did not desire to be acquired, it would be well-advised to terminate the plan itself and to make good business use of the proceeds. K would be a less attractive takeover candidate in that event, for it would not have \$100 million in readily-available cash as an inducement to a potential acquirer. Furthermore, K may even be able to establish a new pension plan.

Case (13): Leveraged acquisition

Another potential buyer of M in Case (1) may be another widely-held public company. That company could borrow the money to buy M stock, perhaps with installment obligations, from the M shareholders. The buying company would deduct its interest expenses, thus reducing its (and M's) Federal income tax liability (perhaps even enabling it to obtain a refund of prior taxes paid) and increasing cash flow. Again, that increased cash flow would make it easier for the borrowed money to be repaid. Again, M would have been acquired largely with untaxed income.

It is possible that the interest deductions on the borrowing would not be large enough to fully offset M's post-acquisition taxable income. However, in a case like Case (13), the buying company could make a section 338 election after acquiring the M stock (as could MM in Case (2)). If such an election made tax sense, making it would have the effect of reducing post-acquisition taxable income. Thus, for example, if M assets needed to be sold to raise cash to service the debt, a section 338 election could insulate M from having to pay taxes on the sale. Or the buying company in Case (13) may have net operating loss carryovers or current operating losses of its own. If so, it could use those to bring post-acquisition taxable income down even further. Finally, M's buyer might cause M to transfer its assets to a partnership composed of M and an unrelated corporation having large loss carryovers. The partnership rules may permit the parties to structure the partnership in such a way that substantially all income from the former M assets would be offset by the loss company's carryovers. If so, little tax would be paid, thus making it easier for M's buyer to make debt service payments.

Case (14): ESOPs

All the stock of Corporation N is owned by individual Z. Z's basis in the N stock is substantially below its fair market value. Z wants to sell most of his N stock. N could set up an ESOP for its employees. N could then borrow an amount equal to, say, 80 percent of the fair market value of its stock from a bank or an insurance company. The loan may be secured by mortgages and the pledges of N's assets. N could then reloan the loan proceeds to the ESOP on substantially the same terms on which it borrowed them. The ESOP could then use the loan proceeds to buy 80 percent of the N

stock from Z. The ESOP would pay off the loan with contributions made to it by N in subsequent years. Z would use the sales proceeds to invest in a portfolio of securities of public companies traded over the New York Stock Exchange.

Under section 1042, this transaction would produce no immediate tax consequences to Z. Recognition of his gain would be deferred. As a result, Z may be willing to sell his N stock for a price lower than would otherwise be the case. The bank or insurance company lender to N, under section 133, would be able to exclude from its gross income 50 percent of the interest income on its loan to N, so it should be willing to lend at a favorable rate of interest. And N generally could deduct that part of its contributions to the ESOP used to pay off principal on its loan to the ESOP. As a result, the dollars used to buy the N stock from Z would not be currently taxable to anyone.

Case (15): Hostile takeovers

Corporation O is a widely-held public company the stock of which is traded on the New York Stock Exchange. The stock is currently selling at \$40 per share. A group of investors determines that, based on the net value of its underlying assets, O is really worth \$80 per share. The investor group, through a newly-created or an existing corporation, begins buying O stock, on the exchange, at \$40 to \$45 per share, largely with borrowed funds. After acquiring 5 percent of O's outstanding stock, the investor group's corporation makes a tender offer, at \$60 per share, for the balance of O's stock. Most of the cash to be used in the tender offer would be borrowed by the tendering corporation. The investor group has financing commitments from prospective lenders under which the corporation can borrow, on an unsecured and subordinated basis, the funds it may need to finance the tender offer at an interest rate of several points over prime. The high rate on the debt ("junk" bonds) reflects the credit evaluation made by the prospective lenders.

The tender offer may be successful. If so, a section 338 election could be made, and interest payments would be deducted by the new corporation. This could reduce post-acquisition tax liability and increase cash flow available to service the debt.

If O does not wish to be acquired by the investor group, a number of other things may happen. Among them are the following 3 possibilities. First, O may try to dissuade the investor group from proceeding with the tender offer by offering to buy back the 5 percent of its stock held by the group. O may offer \$60 per share. If this "greenmail" offer is accepted, O might claim (based on very dubious authority) a tax deduction for all or a portion of the \$60 per share, and the investor group's corporation would probably claim that its profit qualifies as long-term capital gain (even though it will generally deduct against ordinary income interest expense incurred to carry the stock). Second, O may search around for a "white knight". If O is successful, it may find a white knight who will buy all of O for \$65 per share. Again, the investor group's corporation will likely claim capital gain treatment. (What the white knight does in the way of acquisition planning (e.g., using borrowed money or making a section 338 election) will depend on the tax profiles of O and itself.) Third, O may set up an ESOP to

buy, with borrowed funds, some of its stock. (This may assist O in fending off the acquisition attempt because the ESOP might be viewed as less inclined to accept the tender offer than would O's public shareholders.) Generally, 50 percent of interest payments made by the ESOP with respect to those borrowed funds would be excludible from the lender's gross income. Furthermore, O would in effect end up with deductions for contributions it makes to the ESOP to enable it to amortize the loan.

IV. PRESENT LAW RULES

Part two of this pamphlet looked, from a tax policy perspective, at how present Code rules may influence whether a corporate acquisition is done and, if so, in what form. Part three discussed hostile takeovers and illustrated the application of general Code rules in the context of simplified acquisition cases. This part discusses, on a more detailed and technical level, many of the operative rules, without regard to whether the acquisition involved is hostile or grew out of a hostile offer.

A. Forms of Acquisition

An acquiring corporation can structure the acquisition of another corporation as a taxable purchase or as a tax-free reorganization. In either case, the transaction can take the form of an acquisition of assets or an acquisition of stock. As indicated in part three, the form of an acquisition is influenced by factors such as the nature of the consideration to be used (e.g., cash, or stock or debt of a party to the acquisition), the opportunity to step up the basis of the acquired corporation's assets, and the question of whether it is advantageous to preserve the acquired corporation's tax history (e.g., net operating loss carryovers, credit carryovers, and built-in losses).

What follows is a technical description of many of the Federal income tax rules that govern corporate acquisitions involving domestic corporations, including the treatment of shareholders of acquired corporations.

1. Taxable acquisitions

If the consideration used by an acquiring corporation is cash or other property (rather than stock of the acquiring corporation or a corporation in control of the acquiring corporation), the acquisition will be a taxable purchase of the acquired corporation's assets or stock. A putative reorganization that fails to qualify for tax-free treatment, where the consideration consists of stock or a combination of stock and cash (or other property), is also treated as a taxable purchase.

a. Asset acquisitions

A taxable sale of assets by a corporation normally results in the recognition of gain or loss to the corporation unless the corporation liquidates within a prescribed period and satisfies certain other requirements (discussed below).²⁹ The acquirer takes a cost basis for

²⁹ This case usually involves nothing more than the sale by a corporation of only some of its assets in the ordinary course of business and its continuation in business. It is not a corporate acquisition at all.

the acquired assets (generally equal, in the aggregate, to the amount of cash and the fair market value of any property used as consideration). No gain or loss is recognized by the shareholders of the selling corporation unless the corporation distributes all or part of the sale proceeds.

Treatment of selling corporation

The selling corporation in a nonliquidating sale recognizes gain or loss equal to the difference between the amount realized (i.e., the cash and the value of any property received) and its basis with respect to each asset. Recognized gain or loss is ordinary income or loss, long-term capital gain or loss, or short-term capital gain or loss, depending on the nature and holding period of the transferred property. For example, if the selling corporation recognizes a net gain from depreciable assets that were used in its trade or business and held for the period required (generally more than 6 months), then the gain may be taxed as long-term capital gain pursuant to section 1231. Ordinary income and net short-term capital gain are taxed to corporations at a maximum rate of 46 percent. A corporation's net capital gain (the excess of net long-term gain over net short-term loss) is subject to an alternative tax of 28 percent if the tax computed using that rate is lower than the corporation's tax would be using the regular rates.

Recaptures.—Part of all of the selling corporation's gain may be characterized as ordinary income under a "recapture" provision. The recapture rules, and similar rules, are generally designed to prevent the conversion of ordinary income into capital gain (or unrecognized gain) by requiring gain on disposition of certain property to be taxed as ordinary income to the extent of deductions previously taken against ordinary income with respect to the property.

Under the depreciation recapture rules of section 1245, gain is taxed as ordinary income to the extent of all prior depreciation deductions taken with respect to personal property. Under section 1250, if part or all of the cost of nonresidential real property qualifying as recovery property was recovered under the accelerated depreciation method, recognized gain is treated as ordinary income to the extent of all prior recovery deductions taken. On the other hand, if the property was not depreciated under an accelerated method, none of the gain is recapture income. Section 1252 provides a recapture rule for transfers of farm land. Under this provision, a portion of the post-1969 amounts deducted for soil and water conservation or clearing land is subject to recapture.

If mining property is included in the assets disposed of, recognized gain is treated as ordinary income to the extent of post-1965 mining exploration expenditures previously deducted under section 617 (reduced by the amount of foregone depletion deductions). Similarly, if oil and gas properties are sold, section 1254 provides for the recapture of amounts deducted for post-1975 intangible drilling and development costs (less the amount of foregone cost depletion deductions). Section 1254 also applies, with respect to post-1977 development costs, to transfers of geothermal property. Depletion deductions are not subject to recapture.

In addition to the recapture of previously-claimed deductions, section 47 provides for the recapture of investment tax credits. If

eligible property is disposed of prior to the end of the period that was taken into account in computing the credit claimed by the taxpayer, then the credit is recomputed. For example, in the case of recovery property that qualified for the regular 10 percent credit, on an early disposition, the credit is recomputed by allowing a 2-percent credit for each full year the property was held. The difference between the credit originally claimed and the recomputed credit is generally treated as a dollar-for-dollar increase in the selling corporation's tax liability for the year of sale. This recapture occurs whether the property is sold at a gain or at a loss.

Sales by liquidating corporations.—In the acquisition context, a corporation selling assets can, under section 337, avoid the recognition of gain (other than recapture and similar income) with respect to sales that occur within a 12-month period beginning on the date the corporation adopts a plan of complete liquidation by distributing all of its assets (less assets retained to meet claims) during such 12-month period. Nor will it recognize loss with respect to any such sales. Section 337 generally does not provide nonrecognition treatment on a sale of assets by a corporate subsidiary, however, unless all corporations in the chain above the subsidiary are also liquidated. Nor does section 337 generally apply if the corporation is a "collapsible corporation" (discussed below).

Ordinarily, the selling corporation recognizes neither gain nor loss on liquidating sales of assets (or on the distribution of its assets in a complete liquidation).³⁰ However, gain is recognized (as ordinary income) to the extent of recapture income under the rules described above. In addition, if the selling corporation maintained inventories using the LIFO (last-in-first-out) method for Federal income tax purposes, the corporation will recognize ordinary income in an amount equal to the excess of the value of the inventory using the FIFO (first-in-first-out) method over the value using the LIFO method. Furthermore, the corporation will recognize income on piecemeal liquidating sales of its inventory. Finally, investment tax credits are also subject to recapture, as described above.

In addition to the statutory recapture provisions, the selling corporation may be viewed as recognizing income on a liquidation (or a liquidating sale) under the "tax benefit" doctrine or assignment of income principle. For example, the U.S. Supreme Court has applied the tax benefit doctrine to tax a liquidating corporation on the distribution of previously-expensed items to its shareholders. *United States v. Bliss Dairy, Inc.*, 460 U.S. 370 (1983), *rev'g*, 645

³⁰ Prior to the enactment of the Deficit Reduction Act of 1984, generally no gain (other than recapture income) was recognized to a corporation that made a nonliquidating distribution of appreciated property with respect to its stock. There were several cases under prior law where the failure to tax currently the ordinary, nonliquidating distribution of appreciated property to a shareholder resulted in tax avoidance. For example, in several widely publicized transactions, publicly-held oil companies transferred royalty interests carved out of long-held working interests in oil and gas leases to a trust and distributed units of interests in the trust to their shareholders without paying any corporate-level tax (except on recapture). Under the 1984 Act, nonliquidating distributions of appreciated property to corporate shareholders are taxable to the distributing corporation. Ordinary distributions to noncorporate shareholders are also taxed to the distributing corporation with limited exceptions. However, except for recapture, liquidating distributions are not taxable events to distributing corporations. In addition, under the 1984 Act, the basis of a corporate shareholder's stock may be reduced by the nontaxed portion of an extraordinary dividend (sec. 1059).

F.2d 19 (9th Cir. 1981). Tax benefit recapture could also apply to require the recognition of income with respect to other items such as bad debt reserves.

Similar rules apply in the case of certain taxable stock purchases if a section 338 election is made (discussed below). In fact, most taxable acquisitions are cast as stock purchases. By using a stock purchase, the acquirer can more easily and deliberately assess the wisdom of making a section 338 election. In the liquidating sale case, there is no decision to be made after the sale: the transaction will be treated as if such an election had been made.

Consequences to acquiring corporation

The acquiring corporation in a taxable purchase of assets takes a cost basis in the acquired assets (sec. 1012). Thus, for example, if appreciated assets are purchased, the basis of the assets are stepped up to reflect the acquiring corporation's cost, regardless of whether the selling corporation is taxed on the appreciation in the value of those assets. Similarly, if the assets purchased have depreciated in value, the basis is stepped down in the hands of the acquiring corporation. The acquiring corporation will not succeed to the tax history (e.g., carryovers) of the selling corporation.

The value of any step up depends, in part, on the nature of the acquired corporation's assets. For example, because land (or goodwill) is not depreciable, the benefit of stepping up its basis is generally realized only on a subsequent disposition of the property (by reducing taxable gain). On the other hand if the basis of a depreciable asset is stepped up, the acquiring corporation will be entitled to larger depreciation deductions than would have been allowed to the selling corporation. Likewise, a step up in the basis of inventory will eventually be reflected in the acquiring corporation's cost of goods sold (and thereby reduce its taxable income).

Shareholders of selling corporation

In general, the sale of a corporation's assets does not generate a tax at the shareholder level. However, if the selling corporation distributes the sale proceeds in a complete liquidation, each of the corporation's shareholders recognizes gain or loss (generally capital in nature) equal to the difference between the value of the liquidating distributions and the basis of the stock (sec. 331).

Possible application of collapsible corporation rules.—The “collapsible corporation” rules are designed to prevent the conversion of ordinary income into capital gain by engaging in an activity through a corporation and, before a substantial amount of the resulting income to be realized is realized at the corporate level, disposing of the stock in the corporation at a price that reflects the unrealized earnings (sec. 341). A shareholder who receives a liquidating distribution from, or sells stock in, a collapsible corporation is generally taxed at ordinary income rates if the gain recognized would otherwise have been treated as long-term capital gain. Individuals are taxed on long-term capital gains at a maximum rate of 20 percent. The maximum rate of tax on ordinary income and net short-term capital gain of individuals is 50 percent.

b. Stock acquisitions

A taxable purchase of a corporation's stock from its shareholders results in the recognition of gain or loss by such shareholders. Gain on stock sales is generally taxed at capital gain rates unless the collapsible corporation rules (discussed above) apply or the stock was not held as a capital asset. Absent an election to treat the stock purchase as an asset acquisition under section 338 (described below), no gain or loss is recognized by the acquired corporation, and the basis of its assets and its tax history are unaffected. However, the acquiring corporation takes a cost basis in the purchased stock.

In the case of widely-held acquired corporations, a common practice is for the acquiring corporation to tender for all of the acquired corporation's outstanding stock and, after purchasing a significant portion of that stock for cash (or installment debt), to cause a newly-formed subsidiary to merge into the acquired corporation under applicable state law in a squeeze-out merger. In the merger, the acquired corporation's remaining shareholders will also receive cash (or installment debt) for their shares. A reverse merger of this type is generally treated as a taxable purchase of the acquired corporation's stock (but see the discussion below regarding tax-free reverse subsidiary mergers).

Treatment of the acquired corporation

The acquisition of part or all of a corporation's stock is generally a nonrecognition event for the corporation. Thus, the basis of the acquired corporation's assets is unchanged. Similarly, there is no effect on other tax attributes such as accumulated earnings and profits. Assuming that the transaction does not run afoul of section 269 (which authorizes the disallowance of certain benefits and deductions if the principal purpose of an acquisition was tax avoidance), net operating loss carryovers and unused tax credits, etc. will remain fully available to the acquired corporation if it continues to carry on a trade or business that was conducted before the acquisition (secs. 382 and 383).³¹ Furthermore, any built-in loss of the acquired corporation will survive. Thus, the acquired corporation generally retains the ability to reduce taxes that would otherwise have been paid with respect to future income.

Stock acquisitions treated as asset acquisitions.—A corporation that makes a "qualified stock purchase" (the acquisition of at least 80 percent of another corporation's voting stock and at least 80 percent of all other classes, excluding nonvoting preferred, within a specified time period) can elect to treat the stock purchase as a direct purchase of the assets of the acquired corporation (sec. 338). If a section 338 election is made, the acquired corporation is generally treated as if it had adopted a plan of complete liquidation and sold all of its assets at the close of the acquisition date under section 337. The acquired corporation is deemed to have sold its assets

³¹ Section 382 imposes special limitations on the use of NOL carryovers following an acquisition. Section 383 provides similar limitations on attributes other than NOL carryovers. The rules are sometimes criticized as too generous to taxpayers and as technically flawed. 1976 amendments to the rules are generally scheduled to go into effect for taxable years beginning after 1985, but they are under reconsideration.

for a price equal to their fair market values. Nonrecognition treatment is generally provided to the acquired corporation to the same extent that gain or loss would go unrecognized if there were an actual sale and liquidation subject to section 337 (see the discussion above). Thus, for example, as in the case of a liquidating sale, the recapture rules are fully applicable.

As of the day following the acquisition date, the acquired corporation is treated as a new corporation that purchased all of the assets held by the acquired corporation. Thus, the basis of each of the acquired corporation's assets is generally stepped up (or down) to its cost to the acquiring corporation (measured by the price paid for the stock and adjusted for liabilities of the acquired corporation and other relevant items).³² In addition, the acquired corporation's tax attributes are unavailable to the acquiring corporation.

Consequences to acquiring corporation

The acquiring corporation takes a cost basis for the purchased stock. Although the acquiring corporation does not directly succeed to the tax history of the acquired corporation, it can benefit indirectly from attributes such as NOL carryovers if the acquired corporation joins the acquiring company in the filing of a consolidated return for Federal income tax purposes and if no section 338 election is made or deemed made. If the acquired corporation is subsequently liquidated into the acquiring corporation, the acquired corporation's tax history will carry over to the acquiring corporation (unless the principal purpose of the transaction was tax avoidance).

Consolidated returns.—Generally, if, after the acquisition, the acquired corporation is included in an affiliated group of corporations that files a consolidated return, the other corporations in the affiliated group can deduct their post-acquisition losses (and sometimes their pre-acquisition losses) against the acquired corporation's post-acquisition income. Conversely, losses recognized by the acquired corporation after the acquisition (other than certain built-in losses, described below) will offset post-acquisition income generated by other members of the affiliated group.

Suppose, for example, that Corporation A anticipates earning substantial taxable income and paying substantial taxes in the years ahead as an independent company. Suppose also that Corporation B anticipates earning economic income but incurring tax losses in the years ahead as an independent company. The tax law provides a strong incentive for one corporation to acquire the other so that B's tax losses will offset A's taxable income with the result that A and B together will pay no taxes. The consolidated return rules are an available vehicle. Thus, those rules may encourage acquisitions to occur which would not otherwise have occurred. For

³² Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a corporation could in some instances acquire the stock of another corporation in a taxable purchase and then effect asset step ups only with respect to selected assets, i.e., where a step up was most advantageous. This selectivity was achieved by causing a partial liquidation of the acquired corporation. TEFRA modified the treatment of a partial liquidation so that only certain noncorporate shareholders of the distributing corporation would be treated as receiving amounts distributed in partial liquidation as in exchange for stock. One of the principal effects of this change was to deny an acquiring corporation a step up in the basis of properties distributed to it by a newly-acquired corporation in partial liquidation. TEFRA also adopted other rules which attempted to prohibit "selective" step ups, e.g., the consistency rules of section 338.

example, some have argued that the ability of a property and casualty insurance company to file consolidated returns with non-insurance companies and, to a lesser extent, the ability of such a company to file consolidated returns with life insurance companies have prompted the acquisition in recent years of many independent property and casualty companies by non-insurance companies or by life insurance companies and caused significant disruption in the property and casualty insurance industry.³³

In addition to the special limitations on NOL carryovers in section 382, under the "separate return limitations year" (SRLY) rules provided by regulation (see Treas. regs. sec. 1.1502-21(c)), NOL carryovers of a newly-acquired member of an affiliated group cannot offset income of other members of the group. (The "consolidated return change of ownership", or "COCO", rule provides similar treatment with respect to the NOL carryovers of an affiliated group acquired by certain persons.) Because an acquired corporation is permitted to use NOL carryovers to offset its "own" income, however the SRLY rules can frequently be avoided by, among other things, diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to a newly-acquired corporation (but see sec. 269).

Applicable Treasury regulations (see Treas. regs. sec. 1.1502-15) also prohibit the use of an acquired corporation's built-in losses to reduce the post-acquisition taxable income of other members of an affiliated group. Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(2)). For example, if the acquired corporation owns a building with a basis of \$100 and a value of \$50 as of the acquisition date, the \$50 potential loss may be treated as a built-in deduction. The built-in loss limitations do not apply unless, among other things, the aggregate adjusted basis of certain assets of the acquired corporation exceeds the value of those assets by more than 15 percent. Further, assuming that section 269 is inapplicable, the application of the SRLY rules to built-in losses can be avoided by causing the acquired corporation to generate additional taxable income (as described above).

Subsidiary liquidations.—Absent a section 338 election, and assuming no significant tax avoidance motive, a corporation can liquidate a newly-acquired subsidiary corporation and directly succeed to the acquired corporation's tax attributes (secs. 332 and 381). No gain or loss is recognized, and no recapture occurs, to the liquidating subsidiary corporation or to the distributee parent corporation (secs. 336 and 332), and the distributee corporation takes a carry-over basis in the assets received in the liquidation (sec. 334). The acquiring corporation's basis in the purchased stock will "disappear".

Section 381 enumerates tax attributes that carry over to a parent corporation as the result of the liquidation of a subsidiary. A major

³³ See "Skinning the Cat", *Forbes Magazine* (April 22, 1985), p. 121.

item is earnings and profits or a deficit in earnings and profits. In general, a deficit in an acquired corporation's earnings and profits cannot be applied against the acquiring corporation's accumulated earnings and profits; however, the deficit can reduce the acquiring corporation's post-acquisition earnings and profits. Thus, even if the acquiring corporation at the time of the acquisition has accumulated earnings and profits, after such earnings and current earnings are paid out as dividends the acquired corporation's deficit could result in the future payment of tax-free dividends (treated as a return of capital to the acquiring corporation's shareholders). Of course, the acquired corporation's deficit in earnings and profits may be unimportant if the acquiring corporation's accumulated earnings and profits are so great that there is little likelihood of reducing them to zero.

Examples

(1) The opportunity to step up basis

The parties to an acquisition may or may not wish to step up the basis of the acquired company's assets. As indicated, there is a tax cost (or "toll charge") to such a step up—recapture income, etc., to the acquired company. As the examples below show, there will be many cases in which a step-up election is not advantageous. Since those step-up and toll charge results are automatic in the case of a liquidating sale of assets by an acquired company, most taxable acquisitions are structured as purchases of stock. In a purchase of stock, step up and recapture will occur only if the buyer so elects. Further, the law gives the buyer some period of time to determine whether the election should be made.

The decision to elect to step up the basis of all assets and pay recapture taxes or, alternatively, to have basis carry over and have no recapture tax, generally is determined with reference to several tax and financial attributes of the acquiring corporation and the acquired corporation. The following example illustrates the net tax benefits and costs of a step-up election under a limited and simple set of assumptions.

Assume that the acquired corporation acquired all its assets on January 1, 1981, and that all its stock is sold on January 1, 1984. Five types of assets are involved in the transaction:

- (1) Section 1245 equipment, in the 5-year ACRS class;
- (2) Section 1250 structures, depreciated under the straight-line method;
- (3) Section 1254 intangible drilling costs (three-tenths of which would have been recovered through cost depletion);
- (4) Lease acquisition costs (three-tenths of which have been recovered through cost depletion); and
- (5) LIFO inventories.

Both parties are assumed to be fully taxable at a 46-percent marginal rate. The acquired corporation has no liabilities. (See Table 6.)

Table 6.—Asset Analysis and Recapture Tax

Assets	Original cost— Jan. 1, 1981	Jan. 1, 1984—			
		Tax basis	Pur- chase price	Recap- ture income	Recap- ture tax
Section 1245 equipment.....	\$10,000	\$4,200	\$8,000	\$3,800	\$1,748
Section 1250 structures ..	10,000	8,000	12,000
Section 1254 IDCs.....	1,000	0	1,000	700	322
Lease acquisition	1,000	700	1,000
FIFO inventory.....	1,750	1,750	1,750
LIFO inventory (excess over FIFO)		75	75	75	35
ITC					400
Total.....	\$23,750	\$14,650	\$23,825	\$4,575	\$2,505

The original cost of the assets was \$23,750. After 3 years, their purchase price (and fair market value) is \$23,825, while their tax basis has been reduced to \$14,650. If the basis is stepped up, recapture tax of \$2,505 must be paid. The net tax benefit of a step-up transaction (determined without regard to present value considerations), after payment of recapture tax, is \$1,681 (assuming that no tax benefit is to be realized with respect to the inventory and, for ease in understanding, disregarding the effect on purchase price of the recapture tax liability). Because recapture tax generally is payable in the first year and the tax savings will occur over the remaining tax lives of the assets, present values must be considered. With the future cost of funds and yield on investments unknown, the parties should consider the transaction under a range of reasonable discount rates. At a 10-percent discount rate there would be a net loss of \$143. At higher discount rates, the loss from a step-up transaction would be greater. No step-up election is indicated. (See Table 7.)

Table 7.—Net Benefit of Step Up

Discount rate	Zero	10%	12%	15%	20%
Net tax savings.....	\$1,681	—\$143	—\$334	—\$562	—\$831

On the other hand, if the facts were changed so that the fair market value (and purchase price) of the assets created by the IDCs and the lease was increased to \$4,000 each, a step-up election would be indicated under any reasonable discount rate. (See Table 8.)

Table 8.—Net Benefit of Step Up with Higher FMV

Discount rate	Zero	10%	12%	15%	20%
Net tax savings.....	\$4,442	\$1,553	\$1,225	\$823	\$326

The parties may forego a step-up election even if the amount of projected tax savings indicates that a step up may be beneficial. There are a number of reasons for this. First, the acquiring corporation may have borrowed substantial sums of money to make the acquisition. It may have difficulty raising additional funds to pay the tax liability attributable to recapture. Second, the Internal Revenue Service, on audit, may challenge the claimed results, particularly the taxpayer's claim as to the value (or cost) of separate assets or their character as depreciable property. In few areas of the tax law is there more opportunity for controversy, especially if the acquired company was a large publicly-held company. As a result, there may be significant uncertainty as to the final costs and benefits. Third, no benefits will be available unless the acquiring corporation or its affiliated group has taxable income in the future against which to apply increased deductions resulting from the step up. An acquiring corporation that assumes without question that it will be able to use those benefits as they become available will be taking some risk.

(2) Preserving built-in losses

If an acquired corporation's assets have an aggregate basis that is materially greater than their value, an acquiring corporation will wish to structure the acquisition so that the basis will carry over (rather than being stepped down to reflect the acquiring corporation's cost). Maintaining the high basis of low-value assets may permit the acquiring corporation to make use of the built-in losses against post-acquisition taxable income. The following example illustrates the manner in which an acquiring corporation could benefit from a built-in loss.

Assume that the acquired corporation holds three types of property:

- (1) Land with a value and basis of \$1 million;
- (2) Equipment that is 5-year recovery property with a value of \$2.5 million and an adjusted basis of \$5 million, which equipment is depreciated using a straight-line method over an optional recovery period of 12 years (resulting in an annual deduction of about \$833,333); and
- (3) Section 1250 structures with a value and basis of \$4 million.

The above example assumes that the remaining recovery period for the equipment is 6 years.

Assuming that the acquired corporation has no liabilities, the acquiring corporation presumably will pay at least \$7.5 million for the stock of the acquired corporation. The aggregate \$10 million basis would survive. Section 269 could apply to disallow depreciation deductions attributable to the \$2.5 million built-in loss with re-

spect to the equipment. See Treas. reg. sec. 1.269-3(c)(1) (to the effect that a corporation which acquires property with a built-in loss and utilizes the property to create tax-reducing deductions may be deemed to have had tax avoidance as its principal purpose). Nevertheless, the acquiring corporation may be able to utilize the built-in loss if it is able to establish that there are business reasons to rebut the presumption of a tax-avoidance motive. Because of the possible application of Section 269, and the resulting uncertainty regarding the acquiring corporation's ability to use the built-in loss, the existence of the loss may not have a significant effect on the purchase price.³⁴

If the acquired corporation could be expected to generate \$750,000 of taxable income (before equipment depreciation) in each of the next 6 years, and the built-in depreciation deductions are allowed in full, the deductions would yield a tax saving of at least \$345,000 each year (46 percent of \$750,000), resulting in an after-tax rate of return at least equal to the pre-tax rate of return of 10 percent.

If the acquiring corporation had simply purchased the assets directly, under the statutory table provided in section 168(b), the maximum depreciation deduction that would have been available in the year of acquisition would have been \$375,000 (or 15 percent of the \$2.5 million cost), rather than \$833,333. Assuming the same 10-percent (pre-tax) rate of return, the acquiring corporation would pay tax on \$375,000 (\$750,000 of income less the \$375,000 depreciation deduction). Assuming a 46 percent tax rate, the after-tax return on a direct purchase would be only 7.7 percent (\$750,000 less the tax of \$172,500) for that year and would not reach 10 percent for any year.

Because the acquired corporation's post-acquisition income in the stock purchase example was insufficient to make full use of the built-in loss, the acquiring corporation may take steps to increase that income. For example, if the acquiring corporation is engaged in the same line of business as the acquired corporation, the acquiring corporation could divert business to its new subsidiary. Alternatively, the acquiring corporation could make a capital contribution of a profitable division to the acquired corporation. These steps could increase the after-tax rate of return above 10 percent—by sheltering income that would otherwise have been taxed to the acquiring corporation.

If the equipment had a value of \$3.5 million, so that the aggregate value of the acquired corporations assets was equal to 85 percent of the aggregate basis, the acquired corporation could join in the filing of a consolidated return without running afoul of the SRLY rules. Thus, any depreciation deductions in excess of the acquired corporation's needs could be used to offset income generated by other members of the affiliated group.

³⁴ On the other hand, if the buyer is not worried about section 269, it should be willing to pay more than \$7.5 million for the stock—\$7.5 million for the assets and something more for the tax benefits that the built-in loss will provide.

2. Tax-free reorganizations

In general, to qualify an acquisitive transaction for tax-free treatment, the shareholders of the acquired corporation must retain "continuity of interest" in the combined enterprise. Thus, among other things, at least a principal part of the consideration used by the acquiring corporation must consist of stock.

The definition of the term "reorganization" is found in section 368(a). This provision lists 4 basic types of acquisitive reorganizations involving unrelated corporations: statutory mergers (or type "A" reorganizations); stock-for-stock exchanges (referred to as "B" reorganizations); transfers of substantially all of a corporation's assets for stock (type "C" reorganizations); and bankruptcy reorganizations (or type "G" reorganizations, which may be acquisitive or divisive in character). In addition to the statutory prescriptions, other rules apply including, for example, the "continuity of business enterprise" rule. See Treas. reg. sec. 1.368-1(d). A qualified reorganization generally results in the nonrecognition of gain or loss by the acquired corporation and its shareholders except to the extent that nonqualifying consideration (or "boot") is used. Further, the acquired corporation's basis for its assets and its tax history carry over.

a. Asset reorganizations

Type A and Type C reorganizations are essentially asset acquisitions in which the acquired corporation goes out of existence. Compared to an A reorganization, the type of consideration that can be used in a C reorganization is limited. On the other hand, the acquiring corporation can pick and choose which liabilities of the target corporation it will assume in a C reorganization. In a type A reorganization, the acquiring corporation assumes all of the acquired corporation's liabilities by operation of law.

Statutory mergers

The type A reorganization is a statutory merger or consolidation under state or Federal law (sec. 368(a)(1)(A)). The statute does not prescribe the type of consideration that must be used in a statutory merger; however, the "continuity of interest" doctrine requires that the consideration include a significant equity interest in the acquiring corporation.³⁵ In the transaction, the acquired corporation normally merges into the acquiring corporation, and the merged corporation's shareholders exchange their stock for consideration provided by the acquiring corporation. There are no express limits on the ability of the acquired corporation to dispose of unwanted assets before the merger.

"Forward" subsidiary merger.—The definition of an A reorganization also includes a "forward" subsidiary merger, in which the acquired corporation merges into a subsidiary of the corporation that provides the stock used as consideration in the merger (sec. 368(a)(2)(D)). To qualify a forward subsidiary merger as a type A re-

³⁵ Compare *John A. Nelson v. Helvering*, 296 U.S. 374 (1935) (where 38 percent of the consideration consisted of nonvoting preferred stock and 62 percent of cash, the requirement was satisfied), with *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (short-term notes did not provide sufficient continuity).

organization, substantially all of the merged corporation's assets must be acquired. Thus, pre-merger dispositions by the acquired corporation are limited. Under Internal Revenue Service ruling guidelines, generally the "substantially all test" is satisfied if the transferred assets constitute 90 percent of the value of the net assets, and 70 percent of the value of the gross assets, held by the acquired corporation immediately before the transfer. Rev. Proc. 77-37, 1977-2 C.B. 568.

"Reverse" subsidiary mergers.—In a "reverse" subsidiary merger, a subsidiary of the acquiring corporation merges into the acquired corporation, with the acquired corporation surviving the merger (sec. 368(a)(2)(E)). Although this transaction is similar to a type B reorganization (described below), it is included in the definition of a statutory merger. The surviving corporation must hold substantially all of the properties of both corporations after the transaction. Also, in the merger, shareholders must transfer stock representing "control" of the acquired corporation in exchange for voting stock of the acquiring corporation. For this purpose, control is defined as ownership of at least 80 percent of the voting stock, and at least 80 percent of every other class of stock, of the acquired company (sec. 368(c)).

Type C reorganizations

A type C reorganization is an acquisition of substantially all of a corporation's assets "solely" in exchange for voting stock of the acquiring corporation (or of a corporation in control of the acquiring corporation) (sec. 368(a)(1)(C)). In determining whether qualified consideration is used, the acquiring corporation's assumption of a liability is disregarded. Under the "boot relaxation rule" of section 368(a)(2)(B), up to 20 percent of the consideration can consist of property other than stock of a party to the reorganization, although the 20-percent limitation is reduced by the amount of liabilities assumed by the acquiring corporation.

The type C reorganization provisions are intended to apply to transactions that are functionally equivalent to statutory mergers. In a statutory merger, the acquired corporation is liquidated by operation of law. Thus, as a result of the Deficit Reduction Act of 1984, the statute requires the complete liquidation of a corporation whose assets are acquired in a C reorganization unless this requirement is waived by regulations. Even if the liquidation requirement is waived, however, the transaction is treated as if a complete liquidation had occurred.

b. Stock reorganizations

A type B reorganization is an acquisition of stock of the acquired corporation solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)), if immediately after the acquisition the acquiring corporation has control of the target corporation. Unlike the reverse subsidiary merger, where the acquiring corporation must obtain control in the transaction, a B reorganization can be accomplished by a "creeping acquisition" of the acquired corporation's stock.

c. Bankruptcy reorganizations

A type G reorganization is defined as a transfer of part or all of a corporation's assets to another corporation in a title 11 or similar proceeding if stock or securities of the transferee are distributed in a transaction that qualifies under section 354, 355, or 356 (sec. 368(a)(1)(G)). To facilitate insolvency reorganizations, the continuity of interest doctrine (described above) is generally applied by reference to the continuing interests of creditors of the debtor (acquired) corporation.

d. Treatment of parties to a reorganization

Acquired corporation

A corporation does not recognize gain or loss on the transfer of its property for stock or securities of a corporation that is a party to the reorganization (sec. 361(a)). If the acquired corporation also receives nonqualifying consideration, then gain (but not loss) is recognized unless the boot is distributed pursuant to the plan of reorganization (sec. 361(b)). In general, the acquiring corporation's assumption of the acquired corporation's liabilities is not treated as boot.

Shareholders and security holders

Generally, no gain or loss is recognized by shareholders or security holders who exchange stock or securities solely for stock or securities in a corporation that is a party to the reorganization (sec. 354(a)).³⁶ If the exchange also involves the receipt of nonqualifying consideration, gain (but not loss) is recognized up to the amount of the boot. Further, part or all of the gain may be taxed as a dividend (at ordinary income rates) if the exchange has the effect of a dividend. In general, a shareholder or security holder is treated as receiving boot if the principal amount of securities received exceeds the principal amount of securities surrendered, if securities are received and no securities are surrendered, or if property other than stock of a corporate party to the reorganization is received.

If the exchanging shareholder or security holder receives only qualified consideration, the exchanging taxpayer takes a basis in the qualified consideration that is equal to the basis of the stock or securities surrendered in the exchange (sec. 358(a)). Thus, recognition of gain is deferred until a subsequent disposition of the stock or securities received. (The appreciation in the stock (or securities) can escape taxation entirely if the shareholder holds the qualified consideration until death. In that case, the basis in the hands of the taxpayer's estate will be stepped up to its fair market value.) Security holders are taxed on the receipt of qualified consideration attributable to accrued interest on securities surrendered (sec. 354(a)(2)).

Boot dividends.—The determination of whether the receipt of boot has the effect of a dividend is generally made by reference to the principles of section 302 (which provides rules for distinguish-

³⁶ The Deficit Reduction Act of 1984 added Code section 1042. It provides an alternative to a tax-free reorganization in which a selling shareholder can sell his stock to an ESOP on a tax-deferred basis.

ing ordinary dividend distributions from capital gain redemptions). Under section 302, a distribution is generally treated as a dividend if the distribution does not effect a significant change in the shareholder's interest in the distributing corporation.³⁷ In the case of an ordinary distribution, the amount is taxed as a dividend to the extent of available (current or accumulated) earnings and profits. Under section 356, however, a boot dividend is taxed at ordinary income rates only to the extent of the lesser of the shareholder's (1) gain, or (2) ratable share of accumulated earnings and profits. Where a taxpayer receives boot, the basis of the boot is generally equal to its fair market value, and the taxpayer's basis in qualified consideration is decreased by the value of the boot and increased by the amount of any recognized gain (including as a dividend).

Acquiring corporation

Section 1032 provides nonrecognition treatment to an acquiring corporation that issues its stock to acquire property, even if the issuance is not part of a tax-free reorganization. Similar treatment is provided if a subsidiary corporation transfers its parent's stock in a qualifying reorganization. See Rev. Rul. 57-278, 1957-1 C.B. 124. See also Treas. prop. regs. sec. 1.1032-2. The acquiring corporation generally takes a carryover basis for assets or stock acquired in a reorganization, increased by any gain recognized to the transferor on the transfer (sec. 362(b)). In addition, the acquiring corporation in an asset reorganization generally "steps into the shoes of" the acquired corporation with respect to earnings and profits, NOL carryovers, and other tax attributes (sec. 381). The special limitations on the use of NOL carryovers do not come into play unless the equity interest received or retained by a loss corporation's shareholders is less than 20 percent of the acquiring corporation's outstanding stock (sec. 382(b)). However, section 269 could apply to disallow NOL deductions if the principal purpose of the acquisition was tax avoidance. If the acquired corporation remains in existence (as in a type B reorganization), it can join in the filing of a consolidated return (as described above in the description of taxable acquisitions), although the SRLY rules (including those rules insofar as they relate to built-in losses) would apply.

Examples

(1) Utilization of acquired corporation's NOL carryovers

The acquiring corporation may structure an acquisition as a tax-free reorganization to preserve the acquired corporation's tax history without maintaining the acquired corporation as a separate entity. The following example illustrates the application of the rules that permit an acquiring corporation to utilize the NOL carryovers of an acquired corporation.

Assume that the acquiring corporation projects that it will have taxable income of \$1 million for each of the next 5 years. Also

³⁷ Compare *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973) (dividend equivalency was measured by shareholders' continuing interests in the surviving corporation after a consolidation of 2 related corporations), with *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978) (where, following a merger, the court tested dividend equivalency by assuming a hypothetical redemption by the acquired corporation before the merger).

assume that the acquired corporation has NOL carryovers of \$20 million and that none of the carryovers will expire before the end of 5 years. The acquired corporation also has assets used in its trade or business, but these assets are not expected to generate taxable income.

If the acquired corporation is merged into the acquiring corporation under section 368(a)(1)(A), the \$20 million NOL carryover will survive and be inherited by the acquirer (sec. 381). Assuming that the acquired corporation's shareholders receive only 5 percent of the acquiring corporation's outstanding stock, the present-law special limitations would disallow 75 percent (or \$15 million) of the NOL carryover (sec. 382(b)). Even so, the \$5 million carryover that remains available would be sufficient to cover the acquiring corporation's earnings over the next 5 years. The stock used as consideration could be nonvoting preferred stock, giving the acquired corporation's shareholders only a limited interest in the acquiring corporation.

Assuming that the acquiring corporation is taxable at a 46-percent marginal rate (and, so, would have paid about \$460,000 in tax for each of the 5 years in question), the use of the acquired corporation's NOL carryover would yield tax savings of \$2.3 million. Of course, the present value of the tax savings would be somewhat less than \$2.3 million, depending on the discount rate used.

The special limitations on the use of NOL carryovers following a reorganization (rather than a taxable purchase) do not require that the acquiring corporation continue the acquired corporation's business, although the continuity of business enterprise doctrine may limit the acquiring corporation's ability to simply dispose of the acquired corporation's unwanted assets. In addition, section 269 may be implicated if the acquiring corporation discontinues the acquired corporation's business. See Treas. regs. sec. 1.269-6 (example (1)). Alternatively, the acquiring corporation might choose to continue the acquired corporation's uneconomic business, to head off assertions that the acquisition was principally tax-motivated. In any event, because of the possible application of section 269, the value of the NOL carryover may be discounted for purposes of setting the value of the consideration paid to the acquired corporation's shareholders.

(2) Acquisitions by corporations with NOL carryovers

Instead of selling a corporation with large NOL carryovers, the loss corporation's shareholders may decide to cause it to acquire another profitable corporation in a tax-free reorganization to make use of its own carryovers. The special limitations on the use of NOL carryovers generally would not apply if the loss corporation's shareholders retained at least 20 percent of the combined enterprise.

B. Financing Aspects of Acquisitions

1. In general

Although a corporation could be acquired solely for cash that has been accumulated, after taxes, by the acquirer, virtually all mergers and acquisitions involve some—often a substantial—degree of

financing. Financing may take the form of either equity (common or preferred stock) or debt. The tax consequences to the parties to a corporate merger or acquisition and their shareholders vary depending on whether debt or equity financing is used. As is discussed, the tax law contains a strong bias in favor of debt financing. Many recent acquisitions have been accomplished using a high degree of leverage.

a. Equity financing

As discussed above, if the acquirer is a corporation, it may issue its own stock in exchange for target stock or target assets. Alternatively, the acquiring corporation might obtain funds by selling its own stock in the market and then using the proceeds to acquire the stock or assets of the target.

If the merger or acquisition is accomplished through the issuance of stock of the acquiring corporation, the transaction will be tax-free to that corporation (sec. 1032) and may be tax-free to the target corporation's shareholders and the target corporation if certain requirements are met. If the transaction involves an exchange of stock or securities by the shareholders of the target corporation, and the exchange fails to qualify under the reorganization provisions of the Code, each shareholder of the target corporation will recognize gain to the extent the value of the stock or securities received exceeds the shareholder's basis in the stock or securities surrendered. Generally, the entire amount of any gain will be recognized in the year of the sale.³⁸

Distributions by the acquiring corporation with respect to stock issued to finance an acquisition, whether to the former shareholders of the target corporation or to others, generally will not be deductible by the acquiring corporation. Moreover, these distributions will generate ordinary dividend income to individual shareholders to the extent of the issuing corporation's earnings and profits. Thus, the income reflected by these distributions generally will be subject to double taxation. Finally, in certain circumstances, payments received by the shareholders in redemption of their stock may be treated as dividend income rather than as proceeds from the sale or exchange of the stock.

One common nontax consequence of using equity rather than debt financing is that interests of the pre-acquisition stockholders of the acquiring corporation may be diluted by the issuance of additional shares of stock.

b. Debt financing

An acquirer may purchase the target corporation's stock or assets using funds borrowed from domestic or foreign banks or other financial institutions or from individual or corporate investors (e.g., pension funds or insurance companies). A corporate acquirer could also borrow from the target corporation or its shareholders by issuing its own debt obligations to the target or its shareholders in exchange for assets or stock. The stock or assets

³⁸ Similar consequences would generally follow from a nonqualifying exchange of assets by the target corporation for stock of the acquiring corporation. In certain circumstances, however, section 337 might permit nonrecognition of gain at the corporate level.

purchased with the proceeds of the debt may be pledged as security for the loan.

Subject to certain limitations,³⁹ interest paid or accrued on a loan is deductible by the borrower for tax purposes (sec. 163). Although payments of interest are in theory ordinary income to the lender, all repayments of loan principal are tax-free.⁴⁰ (Of course, repayments of principal will result in some taxation of the lender if the loan was part of an installment sale under section 453.)

Financing an acquisition using corporate debt does not directly affect the equity of the shareholders of an acquiring corporation. However, as discussed in parts two and three, the use of debt financing can reduce significantly the after-tax cost of an acquisition. This follows from the simple rule that the issuer of debt can deduct the amount it pays for the use of the borrowed funds (interest), while the issuer of stock cannot deduct the amount it pays to those providing the capital for the use of that capital (dividends).⁴¹

2. Specific provisions affecting debt-financed acquisitions

a. Cost recovery allowances and installment reporting

The Accelerated Cost Recovery System (ACRS) generally permits the cost of depreciable assets acquired after 1980 to be recovered on a much more accelerated basis than assets acquired in previous years. The deductions allowed under ACRS in early periods of use of an asset are often very large when compared to the actual economic deterioration of the asset.

In some cases, the tax benefits resulting from ACRS may provide a target corporation with significant liquid assets and an attractive cash flow, thus increasing its attractiveness as a takeover candidate. In addition, similar benefits may provide a large portion of the debt service costs incurred by an acquirer in financing an acquisition (or internally-generated cash used in the acquisition). For example, the large deductions available under ACRS in the early years following acquisition may shelter income of the acquirer (in the case of an asset purchase) or of the target corporation (in the case of a stock purchase followed by a section 338 election), thus

³⁹ In limited circumstances, section 279 denies a deduction for interest on corporate acquisition indebtedness. The limitation applies to interest in excess of \$5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of the stock, or two-thirds of the assets of, another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated; (2) the debt carries an equity participation (for example, includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) the issuer is thinly capitalized (i.e., has an excessive debt-to-equity ratio) or projected annual earnings do not exceed 3 times annual interest costs.

⁴⁰ By contrast, as noted above, payments in redemption of corporate stock may be treated as dividends (ordinary income) rather than as proceeds from a sale (which would permit the recipient a tax-free recovery of its basis in the stock).

⁴¹ Some corporations which have sufficient earnings to pay dividends under applicable state corporate law do not have taxable income for Federal income tax purposes. These corporations would receive no current tax benefit from interest deductions. Instead of issuing debt obligations, therefore, they may issue preferred stock with substantial debt-like characteristics or common stock. Because of the 85 percent dividends received deduction, the preferred stock would likely be acquired by taxpaying corporations. The result is that the tax benefits of the financing (i.e., deductions for financing costs) are in part passed on to the buyer of the stock, which can better use them. However, as a result of the 1984 Act, if a corporation borrows the funds used to purchase dividend-paying stock, the dividends received deduction may be reduced in certain situations (sec. 246A). The amount of the reduction is determined by the degree of leverage involved.

reducing tax liability. These tax savings are the equivalent of cash payments to a taxpayer.

The basis of the acquired assets for depreciation purposes is the cost of the assets or, where a section 338 election is made, the cost (with adjustments) of the target stock. Under long-established principles of tax law, the cost of an asset includes not only cash paid but the principal amount of any purchase-money debt.⁴² This debt may be represented by an installment note, in which case the aggregate tax benefits available to the parties may be magnified. Under section 453, gain on an installment sale may be deferred and recognized by the seller as payments of principal are received if, among other things, the installment obligation received is not payable on demand or readily tradable. Thus, while the seller recognizes gain on a deferred basis (which gain generally is treated as capital gain), the purchaser immediately receives a cost basis which includes the full principal amount of the note. If a target's assets have been purchased (or its stock purchased and a section 338 election made), some or all of that cost may be allocable to depreciable assets.

Because the sales proceeds realized by a seller in an installment sale qualifying under section 453 are not reduced in the year of sale by taxes, the seller can realize a higher after-tax return on the proceeds than if the installment method were not used or available. Furthermore, under present law, the seller may be able to raise cash by borrowing against the installment obligation without triggering any tax consequences. If so, the primary reason for permitting section 453 to apply—that the seller has no cash with which to pay current taxes—disappears.

Example

Assume that on January 1, 1986, P Corporation purchases all of the stock of T Corporation from T's sole shareholder, A. As consideration for the stock, P gives A its non-readily tradable term installment note with a face amount and a fair market value of \$1 million. The note bears interest at an annual rate of 13 percent,⁴³ payable annually in arrears. The principal amount is payable in a lump sum on December 31, 1995. A's adjusted basis in his stock is \$200,000, as is T's basis in its assets.

If A does not elect out of the installment method, under section 453 he will recognize no gain in the year of sale. He will report \$130,000 of ordinary interest income in each of the 10 years the note is outstanding and will recognize \$800,000 of capital gain income in the year the note matures (1995). The tax at that time will be \$160,000.

By contrast, if A had received \$1 million in cash or marketable securities in lieu of the installment note (and therefore would have been ineligible for installment reporting), he would have recognized \$800,000 of capital gain income in 1986, would have paid \$160,000 in taxes in that year, and would have had only \$840,000 in proceeds left to reinvest. Assuming he could have invested the pro-

⁴² The principal amount may be adjusted downward if the debt instruments bears inadequate interest (see secs. 483 and 1274).

⁴³ Assume that this rate is adequate for purposes of section 1274.

ceeds at the same pre-tax rate of return he earned on P's installment note (13 percent), his annual income from the reinvestment would be only \$109,200 (leaving as little as \$54,600 after taxes), compared to \$130,000 (as little as \$65,000 after taxes) in the installment method case.

Even if A uses the installment method and recognizes no gain on the sale until 1995, if P makes a section 338 election T will be entitled to an immediate step up in basis in its assets. T's new basis will be based on \$1 million, the purchase price of the T stock. To the extent T's assets are depreciable, T could immediately begin to take depreciation deductions using a \$1 million basis rather than a \$200,000 basis. Furthermore, P will be deducting \$130,000 each year as interest expense. These deductions could be used by P to offset T's income or P's income.

b. Provisions relating to qualified pension plans

Overfunded pension plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax laws ("qualified pension plan"), a trust holding the plan's assets generally is exempt from Federal income tax. Furthermore, contributions to a qualified pension plan by an employer are deductible, within specified limits, in the year for which the contributions are made. The participants in the plan, however, are not taxed on plan benefits until the benefits are distributed.

Under a defined benefit pension plan,⁴⁴ minimum funding rules apply that require an employer to make contributions to the plan so that an employee's retirement benefit will be fully funded upon his retirement. Under certain of the permissible funding methods, an employer's funding costs are levelled over an employee's working years even though the costs of benefits earned normally increase as the employee approaches retirement age. Thus, at any time, the plan may have assets that exceed the present value of the liabilities to employees for previously accrued benefits.

In addition, in recent years, high interest rates have contributed to substantial increases in the value of the assets held in many trusts under qualified pension plans. Although these increases in value must be amortized over 15 years in calculating the employer's minimum funding costs, one effect may be that a plan's assets may be substantially greater than its liabilities prior to the time the amortization period has expired.

If a qualified pension plan is terminated, the rights of employees to benefits accrued up to the date of the plan termination must be nonforfeitable. Although a qualified pension plan must be established for the exclusive benefit of employees, present law provides that an employer is entitled to recoup excess plan assets on plan termination to the extent the plan has assets remaining after all obligations to employees have been satisfied (i.e., to the extent that the plan is overfunded). If the excess assets represent amounts previously deducted by the employer or earnings on those amounts,

⁴⁴ A defined benefit pension plan is a plan under which an employee accrues ("earns") a specified retirement benefit that is not related to the amount of assets held by the plan or any account balance maintained for the employee.

the employer is required to include the recouped amounts in gross income for the year in which the amounts are received. Other deductions or credits (including loss carryovers) that the employer is entitled to claim may be used to offset the tax on this income.

An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover.

It has been suggested that, as companies become more familiar with the existence of excess assets in their pension plans, the role of overfunded pension plans for an acquiring company will be diminished. On the other hand, it has been argued that an overfunded plan represents an attractive source of cash even if the value of the assets are included in the purchase price. Under the latter analysis, companies with overfunded pension plans will continue to be attractive takeover targets.

Another possibility is that a company will itself terminate an overfunded pension plan to assist its efforts to thwart a hostile takeover attempt. This can be accomplished in one of 2 ways. First, the company can invest the excess assets in plant equipment, thus making itself less attractive than if it held a large amount of liquid assets. Alternatively, the company can establish an employee stock ownership plan funded with the excess assets.

Employee stock ownership plans

An ESOP is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan which may be utilized as a technique of corporate finance. Under an ESOP, employer stock is acquired for the benefit of employees. ESOPs are accorded preferential tax treatment under the Code as an incentive for corporations to finance their capital requirements or their transfers of ownership in such a way that employees have an opportunity to gain an equity interest in their employer. Thus, ESOPs are exempt from tax under the rules generally applicable to qualified employee benefit plans, and, subject to statutory limitations, employer contributions to an ESOP are tax deductible.

An ESOP that borrows funds to purchase employer securities is referred to as a "leveraged" ESOP. An employer may deduct the full amount of any contribution to a leveraged ESOP that is used by the ESOP to pay interest on a loan to purchase employer securities and may deduct amounts used to repay loan principal in amounts up to 25 percent of payroll costs.

The Deficit Reduction Act of 1984 added additional tax incentives to the establishment and use of ESOPs, including the following:

- (1) A taxpayer owning qualified securities in an employer corporation may defer recognition of gain on the sale of the securities to an ESOP that holds at least 30 percent of the employer's securities, to the extent the taxpayer reinvests the proceeds in securities of certain domestic corporations.

(2) A corporate employer may deduct dividends paid on employer stock held by an ESOP and allocated to participants' accounts if the dividends are paid currently to employees.

(3) A bank, insurance company, or corporation actively engaged in the business of lending money may exclude from its gross income 50 percent of the interest earned with respect to any loan the proceeds of which are used by an ESOP to purchase employer securities.

(4) Executors eligible under Code section 6166 to make deferred payments of estate taxes may be relieved of liability to the extent that qualified employer securities are acquired from a decedent by an ESOP, pass from a decedent to an ESOP, or are transferred to an ESOP by the decedent's executor if the ESOP is required to pay the liability.

A leveraged ESOP can be used by an employer as a technique of finance to obtain funds for working capital, plant expansion, or other purposes. Use of this financing technique can result in a lower cost of borrowing than would be available if conventional debt or equity financing were used. In a typical transaction, the employer enters into a contract with the ESOP to sell the ESOP a specified number of shares of its stock. The ESOP borrows the funds needed to purchase the shares from a bank or other lender and pays them over to the employer in exchange for the stock.⁴⁵ In subsequent years, the employer makes tax-deductible cash contributions to the ESOP in the amount necessary to amortize the loan principal and make interest payments thereon.⁴⁶

A leveraged ESOP may be used not only to provide the company with working capital but also to finance an acquisition of the stock or assets of another corporation. In a typical case, a leveraged ESOP maintained by the acquiring corporation or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities from the employer. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company. Within statutory limits, the employer's contributions to the leveraged ESOP to enable it to amortize the loan will be deductible. In this manner, the corporation may reduce its after-tax cost of financing the acquisition.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly-acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases stock in the subsidiary from the subsidiary (or from the acquiring corporation). The acquiring corporation then uses the proceeds of this sale to pay off the original acquisition.

⁴⁵ The lender usually requires either that the employer guarantee the loan or that the stock purchased with the loan proceeds be pledged as collateral. Because of the 50-percent interest exclusion available to the lender, it may be able to lend to the ESOP at a lower rate than it lends to its regular customers not utilizing ESOP financing techniques (or other tax-favored financing techniques.)

⁴⁶ Alternatively, the employer may take out the loan itself and sell its stock to the ESOP in exchange for the ESOP's installment note. The employer will make (deductible) contributions to the ESOP in future years that will enable the ESOP to pay off the note. These payments will be used by the employer to repay its lender.

tion loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.⁴⁷

Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts. By selling stock to an ESOP, a company may make it difficult for a hostile bidder to acquire control, since stock held by an ESOP might be expected to be voted to keep the company independent. Proceeds of the sale are generally available for any purpose. Moreover, a sale of stock to the ESOP will not necessarily dilute management's control of the company to the same degree as a sale to outside parties. The stock purchased by the corporation for its employees is held in a suspense account and released for allocations to employees' accounts as the acquisition loan is repaid. Prior to the time the acquisition loan is repaid and stock is allocated to employees' accounts, the shares may be voted by plan trustees on the employees' behalf in accordance with the fiduciary standards of the Employee Retirement Income Security Act of 1974. In some cases, the shares sold to the ESOP may have more limited voting rights than are granted to shareholders of public companies.

Leveraged ESOPs have also been used to accomplish leveraged buy-outs by persons desiring to take the company private.

Other issues relating to qualified pension plans

In addition to the potential use of qualified pension plans (including ESOPs) as financing tools in mergers and acquisitions, other issues are presented when companies, who maintain qualified pension plans, merge. These issues depend, in part, upon whether the successor company continues to maintain any of the qualified pension plans of the predecessor company. A full analysis of these issues is beyond the scope of this pamphlet.

c. Provisions relating to international taxation

Interest and dividends paid to foreign lenders and shareholders

In general, U.S. source dividends and (prior to the 1984 Act) interest paid to a nonresident alien individual or foreign corporation that are not "effectively connected" with the conduct of a U.S. trade or business of the individual or corporation are subject to tax at a flat rate of 30 percent (secs. 871 and 881). The payor is obligated to withhold the appropriate amount of tax (secs. 1441, 1442). Interest and dividends paid by a U.S. corporation on its debt obligations are generally treated as U.S. source income.

In many cases, the interest withholding tax imposed by sections 871 and 881 of the Code is reduced or eliminated by the provisions of an income tax treaty between the United States and the country in which the recipient resides. Furthermore, under the 1984 Act, interest paid to certain foreign persons with respect to certain portfolio debt investments is wholly exempt from U.S. tax. Accordingly,

⁴⁷ If the management and shareholders of the target company cooperate in the acquisition, it is possible that a portion of the proceeds of the sale of target stock by original target shareholders would qualify for tax-free rollover under section 1042. Thus, the acquiring corporation and the target shareholders could agree in advance that a portion (enough to qualify the ESOP as a 30-percent shareholder) of their shares would be purchased by a leveraged ESOP established by the target and the balance by the acquiring corporation. The proceeds of the sale to the ESOP might qualify for tax-free reinvestment under section 1042.

interest that is fully deductible by a U.S. corporate payor may be received wholly free of U.S. taxation by the foreign lender.

U.S. source dividends, although not deductible by the U.S. payor, may also be subject to a reduced withholding tax pursuant to a treaty between the United States and the shareholder's country of residence.

Sourcing of interest expense

A U.S. taxpayer may generally claim a credit against its U.S. tax for income taxes paid to a foreign government. In order to prevent foreign taxes from offsetting taxes on U.S. source income, however, the Code limits the credit to the amount of U.S. tax that would have been payable on the foreign income. The maximum foreign tax credit available to a taxpayer in a particular year is the amount of the foreign tax multiplied by a fraction the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is its worldwide taxable income. Thus, a corporation increases its limiting fraction, and hence its usable foreign tax credit, to the extent it can treat income as foreign source income. The same result is achieved when an expense is treated as U.S. rather than foreign source.

A multinational corporation (one with significant foreign as well as domestic assets and earnings) seeking to acquire a domestic corporation using borrowed funds may not be able to increase the utility of the foreign tax credit by virtue of the borrowing. Treasury regulations require that a taxpayer's interest expense be allocated between U.S. and foreign source income based on the relative value of the taxpayer's assets. Thus, the multinational's foreign assets would normally attract a portion of the interest expense on the acquisition indebtedness.

The sourcing rules under present law, however, provide ample opportunity for manipulation by a corporation seeking to maximize its foreign tax credit utility. To avoid having the interest expense on acquisition indebtedness reduce its foreign source income, and hence the foreign tax credit limitation, the corporation may have the acquisition indebtedness incurred by a related corporation (e.g., a parent holding company) whose income is entirely derived from U.S. sources. In this manner, the interest expense would not affect the corporation's foreign tax credit, but, as a member of the parent's affiliated group, the corporation would nonetheless receive the benefits of the acquisition indirectly.

d. Provisions relating to partnerships

The tax law permits a partnership to flow through to its partners items of deduction and loss paid or incurred by the partnership. In some cases, general or limited partnerships have been used to acquire the stock (or assets) of a target corporation, using both funds borrowed by the partnership from institutional lenders and funds contributed as equity by the partners. Interest paid on the acquisition indebtedness is usually deductible by the partners, generally on a pro rata basis although special allocations may be possible.

In these situations, no dividends received deduction is available to a partnership or its individual partners with respect to dividends received from the target corporation. However, to the extent the

partners are not corporations, dividends received will not trigger the extra 6.9 percent tax imposed on most intercorporate distributions. Furthermore, the partnership may end up owning and operating the business of the target corporation directly, including after a section 337 transaction. In such a case, tax benefits generated by the business will pass through directly to the partnership's partners, again, generally on a pro rata basis although special allocations may be possible.

The partnership provisions may also permit an acquired corporation to shelter taxable income with loss carryovers of an unrelated corporation, thus making it easier for any money borrowed in connection with the acquisition to be paid off with pre-tax dollars.

C. Golden Parachutes

Corporations are generally permitted a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, reasonable compensation for salaries or other compensation for personal services actually rendered qualifies as ordinary and necessary expenses. In recent years, many corporations have entered into arrangements, commonly called "golden parachutes", to provide substantial payments to top executives and other key personnel of the corporation in connection with any acquisition that might occur.

Golden parachutes are designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with an acquisition. If the takeover does not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could effect the preservation of the jobs of such personnel. Where no takeover had yet commenced but the corporation viewed itself as an unwilling potential target, golden parachutes were often entered into to discourage potential buyers from becoming interested.

Sometimes, an acquiring corporation will enter into long-term employment contracts or similar arrangements with key personnel of the acquired corporation. These arrangements can remove the incentive for such personnel to examine a proposed takeover carefully.

The 1984 Act imposed significant tax burdens on the use of certain kinds of arrangements of a type described. Under the 1984 Tax Act, no deduction is allowed for "excess parachute payments". Further, if any such payment is made by the acquiring company, or a shareholder of the acquired for the acquiring company, it will not be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company. Finally, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

V. POSSIBLE CHANGES IN THE FEDERAL TAX RULES APPLICABLE IN HOSTILE TAKEOVERS

Many of the Federal tax rules operating in the context of a hostile takeover or a hostile takeover attempt are general Code rules, e.g., the deductibility of interest. Others are generally applicable in the context of a corporate acquisition, be it hostile or friendly. These include, for example, the reorganization rules and the rules of sections 337 and 338. Changes in these general rules have been suggested from time-to-time.⁴⁸ Other changes have been suggested which are more narrowly targeted against hostile acquisitions and hostile acquisitions attempts. Some of these are described below. All involve important policy issues, tax and non-tax, as well as significant technical difficulties.

“Greenmail”

S. 420 (Senators Boren and Nickles) would impose a 50 percent nondeductible excise tax on certain persons realizing “greenmail” profits. The tax would be imposed only on gain realized on the sale or exchange of stock in a corporation by a 4-percent shareholder (after application of the attribution rules of section 318) of the corporation who held the stock involved for less than 2 years if there was a public tender offer for stock in such corporation during the 2-year period ending on the date of realization (or, in the case of S. 476, a 4-percent shareholder submitted a written proposal to such corporation setting forth a plan involving a public tender offer). Both bills defines “public tender offer”, and both contain exceptions for certain persons.

S. 632 (Senator Chafee) would make it clear that the payor of greenmail (generally as defined in S. 420) would be entitled to no deduction for amounts paid to redeem its own stock. Nor would a deduction be allowed for payments to reimburse certain persons for expenses paid or incurred in connection with the redemption or the public tender offer.

Interest

S. 420 and S. 632 would disallow deductions for interest paid or accrued on indebtedness incurred or continued to acquire or carry stock in a corporation (or, in the case of S. 632, corporate assets) acquired pursuant to a hostile offer. However, under S. 420, the rule would not apply in the case of a hostile qualified stock purchase by a corporation. A “hostile offer” is defined as an offer to acquire stock of a corporation if such offer is disapproved by a ma-

⁴⁸ See, e.g., the report of the staff of the Senate Finance Committee, *The Reform and Simplification of the Income Taxation of Corporations*, S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983); the recent Treasury Department proposal (November 1984); and Joint Committee on Taxation, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985.

jority (consisting of at least 2 members) of the continuing independent members of the corporation's board of directors. A definition of an independent board member is provided. A "hostile qualified stock purchase" is a qualified stock purchase (sec. 338(d)(3)) if any portion of the stock included in such purchase was acquired pursuant to a hostile offer.

S. 476 would disallow deductions for interest paid or accrued with respect to hostile acquisition indebtedness. "Hostile acquisition indebtedness" means any junior obligation (i.e., "junk" bonds) issued in connection with a hostile acquisition. A "hostile acquisition" includes certain corporate-level transactions involving a target corporation and any other person (or group of persons acting in concert) who acquired at least 20 percent of the stock of such corporation in the preceding 12 months, but only if the corporate-level transaction, before its consummation, was not formally approved by a majority (consisting of at least 2 members) of the independent board members of such corporation. The term "junior obligation" means any evidence of indebtedness which is (1) expressly subordinated in right of payment to the payment of substantial unsecured indebtedness of the issuer or the target corporation, (2) indebtedness of a person more than 50 percent of the gross assets of which is (or, following the acquisition, will be) represented by stock of the target corporation, cash, or cash equivalents, or (3) is rated at least 2 ratings inferior to the rating of any other substantial class of indebtedness of the issuer or the target corporation. Certain special rules relating to refinancing, guarantors, and assumptions, etc. are also provided.

Mandatory section 338 election

S. 420 and S. 632 would treat a section 338 election as having been made in the case of every hostile qualified stock purchase. Furthermore, section 337 would not apply for purposes of determining the amount of gain recognized by the acquired corporation as a result of the transaction. S. 632 would provide, in addition, that taxes imposed on the acquired corporation be reason of the deemed section 338 election would not increase the basis of the acquired corporation in its assets.