[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

(H.R. 4562, H.R. 5517, H.R. 5719, H.R. 5855, and H.R. 6295)

RELATING TO

TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON MAY 24, 1982

PREPARED BY THE STAFF OF THE

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INTRODUCTION

The House Ways and Means Subcommittee on Select Revenue Measures has scheduled a public hearing on May 24, 1982, on bills relating to the tax treatment of corporate mergers and acquisitions. Five bills are listed for the Subcommittee hearing.

The bills described in this pamphlet are the following: (1) H.R. 6295 (Mr. Stark); (2) H.R. 5719 (Messrs. Harkin, Mitchell of Md., Murphy, and Bedell); (3) H.R. 5517 (Mr. Evans of Iowa); (4) H.R. 4562 (Mr. Dorgan, et al.); and (5) H.R. 5855 (Mr. Stark). H.R. 4562 and H.R. 5855 are essentially the same, except for their effective dates, and are therefore described together.

The first part of the pamphlet is an overview of present law tax treatment and the bills. This is followed by a more detailed description of the bills, including present law, issues, statement of the problem, explanation of provisions, and effective dates.

I. OVERVIEW

A. Basic Objectives of the Bills Scheduled for Subcommittee Hearing

H.R. 6295

The provisions of the bill are intended to further the following general principles:

(1) If the acquisition is treated for tax purposes as a purchase of certain assets from an ongoing corporation with continuing tax attributes, gain should be recognized with respect to those assets by the acquired corporation to the same extent as would be required by a direct sale of those assets.

(2) If the acquisition of another corporation is treated as a liquidation of that corporation for tax purposes, recapture items attributable to all assets should be taken into account currently to the same extent as would occur under the generally applicable corporate liquidation rules.

(3) Within the constraints of the two principles above, an acquiring corporation should have the flexibility to treat a corporate acquisition either as a purchase of assets (with the advantages and disadvantages of that treatment) or as a continuation of the acquired corporation (with the advantages and disadvantages of that treatment) but should not be permitted to treat the acquisition as both (a purchase of some assets and a continuation of tax attributes and basis for other assets).

(4) Tax-motivated acquisitions of loss corporations to utilize loss and tax credit carryovers should be deterred by reducing the corporation's carryover attributes whenever those who were shareholders when the losses were incurred do not continue a significant ownership interest in the corporation.

Other bills

Generally, the provisions of the other bills scheduled for the subcommittee hearing are intended to achieve the following objectives:

(1) Encourage competition by deterring mergers and corporate takeovers tending to result in economic concentration through the imposition of an excise tax or the disallowance of income tax deductions for interest on acquisition indebtedness.

(2) Prevent the use of available credit to finance certain corporate acquisitions.

B. Present Law Background as to Corporate Distributions and Sales

Property distributions

Generally, under existing law, no gain or loss is recognized to a corporation when it distributes property to its shareholders. Such distributions may be made in the ordinary course of corporate activities, in which case they are normally treated as dividends to the shareholders, or they may be distributions in liquidation of the corporation, whether a partial or complete liquidation, in which case they are treated as taxable exchanges of stock for property by the shareholders. However, when there is a liquidation of a subsidiary corporation, 80 percent or more of the stock of which is owned by its corporate parent, normally there is no gain or loss recognized to either the subsidiary or parent corporation and the tax attributes of the subsidiary, including the basis of its assets, are retained in the parent corporation. If, however, one corporation purchases 80 percent or more of the stock of another corporation which is liquidated under a plan adopted within 2 years of the stock purchase, the acquiring corporation receives the same tax treatment it would have received if the subsidiary's assets were purchased directly. The subsidiary's tax attributes are accordingly terminated, and the basis of its assets are stepped up to reflect the parent corporation's cost for the stock.

Present law does require a corporation distributing property in redemption of its stock to recognize gain on the distribution in certain cases, but the requirement does not apply to distributions in partial or complete liquidation. Further, there are exceptions to the requirement that taxpayers have attempted to exploit in a number of recent transactions by structuring a purchase of securities from a corporation as an indirect purchase by first purchasing the stock of the selling corporation and acquiring the desired securities in a subsequent redemption of the stock.

Although, except for certain redemptions, gain is not recognized to a corporation distributing property to its shareholders, the basis of the assets is generally stepped-up to reflect their current value, and the corporation becomes liable for any tax attributable to recapture of the investment tax credit, prior depreciation, intangible drilling and development costs, and other items. There is no current recapture, however, on a complete liquidation of a subsidiary corporation under which the basis of the property is retained in the parent corporation. Further, nonliquidating distributions to a corporate shareholder generally are treated as distributions only to the extent of the distributing corporation's basis adjusted to reflect recapture income, and the basis to the shareholder corporation is limited to that amount.

Sales of property

A corporation which sells assets has gain or loss recognized to the same extent as other taxpayers, including sales the proceeds from

which qualify for partial liquidation treatment when distributed to the shareholders. Present law does provide nonrecognition of gain or loss from sales of property by a corporation which is completely liquidated within 12 months after the adoption of a plan of liquidation.

Historical background of present treatment

The nonrecognition of gain or loss afforded to a corporation distributing appreciated or depreciated property is generally attributed to the Supreme Court's decision in *General Utilities & Operating Co.* v. *Helvering* 296 U.S. 200 (1935). This decision, generally referred to as the *General Utilities* doctrine, is now incorporated into the statutory rules governing ordinary distributions as well as distributions in partial or complete liquidation. Present law also extends nonrecognition to sales of assets by a corporation that is in the process of completely liquidating.

The nonrecognition rules of present law were adopted before the additions to the tax law of requirements that past tax benefits be recaptured when property is disposed of. These requirements have been made applicable generally when a corporation disposes of property by distribution or sale when the basis of the assets disposed of is stepped up, whether or not the provisions for nonrecognition of gain or loss on distributions, or sales in complete liquidation, are applicable to the transaction. The consolidated return regulations permit avoidance or deferral of recapture when property is transferred from one member of the consolidated group to another in a transaction that would normally be treated as taxable to a shareholder corporation and that also results in a stepped-up basis, as in the case of a partial liquidation.

Views on present law

One view that has been advocated assumes that nonrecognition of gain or loss will continue to apply as under existing law to property distributions and that present law should only ensure that all recapture items result in current taxation whenever the basis of property is stepped up. Another view relates to the inconsistency with which the nonrecognition of gain or loss rule applies. Existing law distinguishes distributions depending on whether or not they are in redemption of stock and applies nonrecognition differently to sales of property than it does to distributions of property. Under this view, the *General Utilities* doctrine, which was the genesis of these rules providing for nonrecognition of corporate level gain, should not be dealt with on a piecemeal basis. If the *General Utilities* doctrine is considered inconsistent with the treatment of a corporation as a taxable entity separate from its shareholders, the tax law could be revised to require gain or loss to be recognized on all property distributions and remove the nonrecognition of gain or loss afforded sales of property in complete liquidation. None of the bills scheduled for the hearing by the Subcommittee would make the substantial changes in the existing basic corporate tax rules to implement this latter view.

C. H.R. 6295—Mr. Stark

Titles I and II Generally

Recognition/nonrecognition of gain rules

The provisions of H.R. 6295 continue the nonrecognition rules stemming from the *General Utilities* doctrine for dividends and distributions in complete liquidation. However, the bill reflects the view that the distinction between sales of assets directly and those affected through stock redemptions as well as the distinction between partial liquidations and for other distributions are unwarranted, insofar as they provide different treatment to the distributing corporation for economically similar transactions.

The distinctions in existing law provide a takeover company with more beneficial treatment if it acquires stock than if it acquires assets directly. Distribution of the assets in a later redemption of the stock, if it qualifies as a partial liquidation, results in nonrecognition of gain to the distributing corporation. If 80 percent or more of the stock of the distributing corporation is acquired and it is thereafter included in a consolidated return with the acquiring corporation, recapture tax can be avoided or deferred as well under the regulations. In either case, the substance of the transaction is the purchase of operating assets but the tax treatment is more favorable for stock acquisitions. If the assets were acquired by direct sale, there would be both gain recognized to the selling corporation and immediate recapture.

Other transactions, not qualifying as partial liquidations, have been structured as stock purchases followed by a subsequent redemption of the stock. These transactions have generally involved an indirect purchase of securities. While there is a requirement that gain be recognized when property is distributed in a nonliquidating stock redemption, there are exceptions, one of which applies when the distribution consists of securities in a corporation, 50 percent or more of the stock of which is owned by the distributing corporation. If the stock purchase and subsequent redemption designed to take advantage of this exception are all pursuant to a plan, the transaction may be viewed as a direct purchase of the securities resulting in gain to the distributing corporation under existing law. Nevertheless, if recognition of gain is the appropriate rule for property distributions in nonliquidating redemptions, it is questionable whether this and other exceptions to the requirement should be retained.

Bill provisions

The bill addresses these problems by repealing the provisions under which a distributing corporation achieves nonrecognition of gain on a partial liquidation as well as certain of the exceptions to the requirement that gain be recognized to a distributing corporation in a nonliquidating redemption. These transactions generally are treated at the shareholder level as sales or exchanges of stock for the distributed

assets, normally resulting in capital gain or loss. Shareholders must satisfy certain requirements under existing law to achieve this treatment for nonliquidating redemptions. The bill would preserve capital gain or loss treatment to shareholders on certain distributions now treated as partial liquidations while in general repealing the partial liquidation provisions for other purposes. Under the bill, a transaction that is treated as a taxable sale or exchange at the shareholder level will be similarly treated by the comporation, except for distributions in complete liquidation.

The revisions that the bill would provide more nearly equate the nonrecognition achieved by property distributions in stock redemptions with the nonrecognition rule applicable to direct sales of property. Under the revised rules, nonrecognition generally would apply in either transaction only if it is in the course of a complete liquidation of the corporation.

Under the proposal, generally excepting only property distributions in the normal course of business or in complete liquidation, gain will be recognized to a corporation disposing of property by direct sale or by distribution if the basis of the property is setpped up on the transaction. The proposal essentially views recognition of gain or loss as the appropriate treatment on the disposition of property for an ongoing corporation that retains the basis and tax attributes for those business assets and business operations that are retained by the corporation. Under existing law, a corporation that completely liquidates has the basis of its assets stepped up in the hands of a buyer or distributee and its tax attributes are terminated. Recapture items generally are subject to current taxation while gain otherwise may be unrecognized whether the assets are sold or distributed. The proposal would state these two principles as explicit rules, overruling any interpretation of existing law, including the consolidated return regulations, that might produce a contrary result.

Treatment of stock purchase as an asset acquisition

The provision of existing law that permits a purchase by one corporation of 80 percent of the stock of another to be treated as an asset purchase applies if the acquired corporation adopts a plan of liquidation within 2 years of such purchase and the liquidation may be deferred for an additional period of time up to 3 years. In the meantime, the acquired corporation and the acquiring corporation may file a consolidated return and the tax attributes of the acquired corporation continue to be reflected on that return. On final liquidation, recapture items of the acquired corporation may be offset by a loss of the acquiring corporation. Complex adjustments are required to reconcile these interim operations of the acquired corporation with the treatment of the stock purchase as a purchase of assets. Continuation of the basis of assets and other tax attributes of the acquired subsidiary is inconsistent with the treatment of the purchase of its stock as a purchase of assets, particularly in the context of a consolidated return.

The bill would replace the provision in existing law with an election pursuant to which the purchasing corporation could elect (within 60 days after purchasing 80 percent or more of the acquired corporation's stock) to treat the acquired corporation as if it had sold

all its assets in a liquidation in which gain or loss would be unrecognized. No actual liquidation would be required. Tax attributes of the acquired corporation would be terminated and it would be included in a consolidated return with the acquiring corporation only as if it were a new corporation that had purchased all the assets of the acquired corporation.

Treatment of affiliated groups

To a limited extent, existing law restricts the provision under which gain or loss is not recognized on sales by a corporation in a complete liquidation. If a subsidiary corporation is liquidated into its parent corporation with continuation of the basis and tax attributes for assets distributed to the parent, the nonrecognition provision is inapplicable. Also, the provision will apply where there are several tiers of corporations between the selling corporation and the ultimate shareholders only if all intervening corporations are also liquidated. In these cases, the selling corporation is liquidated in form only and its ongoing business activities and tax attributes continue in a different corporate shell.

The bill places greater emphasis on the distinction between a complete liquidation and other transactions, such as distribution by a continuing corporation, than does existing law. Generally gain will not be recognized on distributions or sales in complete liquidation but will be recognized on other transactions. It is possible for a single corporation or a group of affiliated corporations to distribute assets within the group or to a newly created subsidiary in a tax-free transaction so as to isolate assets in a corporation to be liquidated or sold. In this manner, business assets that have been historically maintained in one corporation may be segregated in different corporate shells so that a transaction that would result in recognition of gain if it were a distribution or sale in the context of the original corporate structure may result in nonrecognition of gain by qualifying as a transaction in a complete liquidation.

The bill deals with this problem by expanding the limitation on nonrecognition treatment in existing law by requiring the liquidation of the entire affiliated group which includes the selling corporation seeking nonrecognition of gain on selling its assets. The bill also requires consistent treatment for all corporations that are acquired as an affiliated group under the election permitting a purchasing corporation to treat a stock purchase as a purchase of assets. This rule is designed to preclude segregation of assets in the acquired group so as to achieve step-up without gain recognition by the purchasing company's selective election for one acquired corporation and a continuation of tax attributes of another acquired corporation. Such selective election is inconsistent with the restriction of nonrecognition to complete liquidation of all properties historically held in a single corporation.

Title III of the Bill

Restrictions on losses

If a corporation with loss carryforwards and unused credits is acquired, existing law restricts their use in some cases. Revision of these restrictions under the 1976 Tax Reform Act are currently in the

law but are not scheduled to become effective until 1984. Unlike the other problems which the bill addresses, which are generally intended to prevent undue selectivity and require consistency of treatment when a corporation's tax attributes are terminated, the restrictions on loss and credit carryforwards are designed to deal with takeover activities in which the acquiring corporation or group is seeking to preserve and exploit the acquired corporation's tax attributes.

The bill provides more restrictive rules than existing law to address the problem of trafficking in loss companies. The investment incentives provided by the Economic Recovery Tax Act of 1981, particularly the accelerated cost recovery system and liberalization of the investment tax credit provisions, probably will increase the number of takeover targets with loss carryforward and unused credits.

Under the revised rules, carryforward of losses would be unaffected if shareholders during the year the loss was incurred retain in the aggregate 60 percent ownership in the year to which the loss is carried forward, and losses would be reduced at the rate of 2.5 percent for each 1 percent by which continuing ownership falls below 60 percent. Losses would be fully eliminated when continuing ownership falls to 20 percent. In the case of a merger or other acquisitive reorganization, continuity would be measured at the time of reorganization and rules are proposed to integrate continuity of ownership after changes in ownership attributable to both reorganizations and other events such as a purchase of stock. Identity of shareholders between the loss year and the carryover year would be required only for those shareholders with a 5-percent or greater interest at either time. The revised rules would apply with respect to stock acquisitions and reorganizations occurring after December 31, 1982. Rules would be provided to coordinate the revised restrictions with the rules of present law.

Changes in corporate form

Title III would also limit the type of reorganization defined as "a mere change in identity, form, or place of organization" to such changes of only a single corporation. This amendment would apply to transactions occurring after August 31, 1982.

D. Other Possible Approaches to Address Corporate Takeover Attempts

One approach to deterring takeover activity within the context of existing law would be to disallow an interest deduction for corporate indebtedness issued to provide consideration for a takeover or attempted takeover. Such an approach might be limited to such indebtedness after a Presidential determination that the use of capital for such purpose is not in the national interest. Disallowance could be limited to cases involving unfriendly takeovers. Another approach would be to impose an excise tax on the acquiring party in a takeover. Bills proposing those approaches are summarized below.

H.R. 5719—Messrs. Harkin, Mitchell of Maryland Murphy, and Bedell

Excise Tax on Mergers

In general, the bill would apply an excise tax of 15 percent on the acquiring party in a corporate takeover. In effect, the tax would be a toll charge on the ability of the acquiring party to use the tax benefits stemming from the takeover. The bill would apply to acquisitions taking place after the date of enactment.

H.R. 5517—Mr. Evans of Iowa

Denial of Deduction of Corporate Acquisition Indebtedness If President Determines Use of Debt for Corporate Acquisitions Should Be Discouraged

The bill would disallow a deduction for interest on corporate indebtedness issued to provide consideration for the assets or stock of another corporation if the President determines it is in the national interest that monetary policy discourage the use of credit to finance corporate takeovers. The bill would apply to obligations issued after the date of enactment.

H.R. 4562—Mr. Dorgan, et al.; and H.R. 5855—Mr. Stark

Denial of Deduction for Interest on Loans in Connection With an Unfriendly Takeover, or Attempted Takeover, of a Corporation

H.R. 4562 and H.R. 5855 would disallow a deduction for interest on any loan if the proceeds are used in connection with the acquisition or tender for acquisition of stock in acquiring or attempting to acquire control of a corporation. The provision would apply where the acquisition is disapproved by a majority vote of the board of directors of the target company. H.R. 4562 would apply to interest paid or incurred after the date of enactment (in taxable years ending after such date) and H.R. 5855 would apply to interest paid or incurred after December 31, 1981.

II. DESCRIPTION OF THE BILLS

1. H.R. 6295—Mr. Stark

Reduction in Tax Incentives for Corporate Takeovers

Title I—Recognition of Gain in Certain Distributions

Present law

Partial liquidations

Under present law, no gain or loss is generally recognized to a corporation on the distribution of property in partial liquidation (sec. 336(a)). The basis of the property to the distributee is generally stepped-up (or down) to the fair market value of the property at the time of the distribution (sec. 334(a)).

The partial liquidation rules together with certain consolidated return regulations may be used under present law to achieve tax treatment for the acquisition of assets in a corporate takeover which is more beneficial than a direct purchase of those assets.

If a corporation seeks to acquire assets from a second corporation, a direct purchase results in taxation to the second corporation of any gain realized on the sale. Instead, the acquiring corporation, through a tender offer, may acquire stock of the second corporation and then have it redeemed for the assets. If the redemption qualifies as a partial liquidation, generally requiring a contraction of the second corporation's business, the second corporation generally recognizes no gain or loss from the distribution of property to the acquiring corporation.

Normally, recapture income (for past depreciation, intangible drilling costs, etc.) would have to be recognized to the distributing company and there would be recapture of investment tax credit. However, when the acquiring corporation obtains control (80 percent of the second corporation's stock), the acquiring and acquired corporations become eligible to file a consolidated return and the consolidated return regulations make it possible through a partial liquidation to defer any recapture income while the property remains in the consolidated group. Similarly, there is no investment tax credit recapture while the property remains in the consolidated group.

Thus, utilization of the partial liquidation and consolidated return rules would permit the avoidance of gain recognition to the selling company on what is in substance a sale of assets and allow a stepped-up basis for the assets distributed in partial liquidation to the acquiring corporation without current taxation of recapture income and without investment tax credit recapture. Moreover, the vagueness of the "partial liquidation" concept permits considerable discretion in selecting assets that can be stepped-up while the distributing corporation retains its tax attributes.

Stock redemptions

Under present law, a corporation must generally recognize gain attributable to appreciated property used to redeem stock issued by the corporation (sec. 311(d)(1)). This recognition rule is subject to several exceptions (sec. 311(d)(2)). The principal exceptions are for certain redemptions in complete termination of interest of a shareholder owning 10 percent or more of the distributing company and certain redemptions involving distributions of stock or obligations of a corporation in which the distributing corporation had at least a 50-percent interest.

Some corporate takeovers have been structured with the objective of qualifying under the exceptions to gain recognition. Typically in these transactions, the acquiring company wishes to acquire a corporation (controlled corporation) which is at least 50 percent owned by another corporation (controlling corporation). To achieve the takeover, the acquiring corporation purchases stock issued by the controlling corporation and then has that stock redeemed with a distribution of the stock of the controlled owned corporation. After the steps are completed, the acquiring company has acquired control of the corporation which it sought to acquire. If the exception to gain recognition for distributions of stock of a 50-percent controlled corporation applies, the acquisition would be achieved with avoidance of gain recognition to the distributing corporation.

If the steps of the transaction were collapsed and viewed in substance as a single transaction, there would be a strong argument that the transaction is really a purchase and sale of the stock of the acquired corporation and gain on the sale must be recognized by the "selling" corporation.

Statement of problem

A stepped-up basis for assets distributed or sold may take place in a complete liquidation without gain (other than recapture income) being recognized to the liquidating corporation. In such a case, all tax attributes of the corporation are terminated. On a partial liquidation, similar nonrecognition benefits apply although the tax attributes of the corporation are unaffected. This combination coupled with the vagueness of the "partial liquidation" concept enables takeover companies considerable discretion to enhance the tax benefits of a corporate takeover.

Under these rules and the consolidated return regulations, recognition of gain and recapture items attributable to assets treated as purchased by the acquiring corporation is deferred or avoided. Also, the acquiring corporation generally has the discretion selectively to treat the acquisition as having been a purchase of some of the acquired corporation's assets and as a purchase of a controlling shareholder's interest in other assets.

In other cases, exceptions to the rule that gain is recognized on distributions of property in redemption of a corporation's stock foster the structuring of transactions in a manner to avoid the recognition of gain on what is essentially a sale of assets.

Issues

(1) Should the partial liquidation provisions be repealed?

(2) Should exceptions to recognition of gain for appreciated property used to redeem stock be repealed?

Bill provisions

Title I of the bill would repeal the partial liquidation provisions. The bill would also repeal certain exceptions in present law (distributions in complete redemption of a 10-percent shareholder and distributions of 50-percent owned subsidiaries) to the requirement that a corporation recognize gain on the distribution of stock, securities, and other appreciated assets in redemption of its stock.

In the case of partial liquidation distributions, capital gain treatment would be retained for shareholders who receive property distributions attributable to a trade or business conducted for at least 5 years by the distributing corporation (currently defined as a partial liquidation). Further, in appropriate circumstances, a series of distributions in complete liquidation of a corporation, defined under present law as a partial liquidation, will continue to be treated as a complete liquidation.

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

Effective date

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

Title II—Election To Have Stock Purchase Treated as Asset Purchase, Etc.

a. Stock purchase treated as asset purchase

Present law

Under present law, no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of an 80-percent owned subsidiary corporation (sec. 332). Generally, the basis of the property distributed in complete liquidation of a subsidiary carries over to the distributee corporation (sec. 334(b)(1)). Certain other tax attributes of the liquidated subsidiary also are carried over to the distributee corporation (sec. 381).

An exception to the general rules for carryover treatment for basis in assets and other attributes is provided for cases which are in sub-

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stance a purchase of assets from another corporation, i.e., a purchase of a controlling stock interest followed by a timely liquidation of the acquired corporation into the acquiring corporation (secs. 334(b)(2) and 381(a)(1)). If this exception applies, the acquiring corporation's basis in the "purchased" assets is the cost of the stock purchased as adjusted for items such as liabilities assumed, certain cash or dividend distributions to the acquiring corporation, and postacquisition earnings and profits of the subsidiary.

Generally, the asset purchase treatment applies when liquidating distributions are made pursuant to a plan of liquidation adopted not more than 2 years after acquiring control of the subsidiary (sec. 334(b)(2)(A)) and the purchases of the controlling interest occurred during a 12-month period (sec. 334(b)(2)(B)). However, the actual liquidating distributions can be made over a 3-year period beginning with the close of the taxable year during which the first of a series of distributions occurs (sec. 332(b)(3)). Thus, this treatment is available even though the liquidation can extend over a 5-year period after control has been acquired.

In these cases, when the assets are treated as purchased by the acquiring corporation, recapture income is taxed to the liquidating corporation, the investment tax credit recapture provisions are applicable, and tax attributes, including carryovers, of the liquidated corporation are terminated. However, in many cases, there are distinct advantages to a purchase of stock rather than a purchase of assets.

The stepped-up basis following a stock purchase will occur although a plan of liquidation is deferred for up to 2 years following the stock acquisition and liquidating distributions are carried out for an extended period beyond that. In the meantime, the acquired corporation is a member of an affiliated group with the controlling corporation and joins in the filing of a consolidated return, if a consolidated return is filed.

During this period, the acquiring corporation or group may enjoy carryforwards and other tax benefits (subject to certain restrictions in the consolidated return regulations) of the ongoing subsidiary even though the tax treatment of the stock purchase and liquidation is designed to parallel that which would apply to a direct asset purchase. When the acquired corporation is ultimately liquidated, its recapture income is permitted to be absorbed by any loss of the other members of the affiliated group on the consolidated return.

Whether or not a consolidated return is filed, the extended period that may elapse between stock purchase and liquidation requires complex adjustments for earnings or deficits of the acquired corporation during the intervening period as well as for sales of assets and other items during such period in order to properly allocate the cost of the stock to the assets upon their ultimate distribution. Existing case law permits a stepped-up basis for assets distributed in liquidation that in some cases exceeds the cost basis that would be applicable if the assets were purchased directly by the controlling corporation. See, *R. M. Smith, Inc.*, 69 TC 317 (1977).

Statement of problem

If the assets were purchased directly, the acquiring company would be unable to avail itself of the purchased company's tax attributes

and recapture income of the selling company could not be offset by losses of the acquiring company. Continuation of the acquired corporation's tax treatment in the manner permitted by existing law is inconsistent with treating the transaction as an asset purchase yet can go on for as long as the parties wish, up to the 5-year limit.

Issue

The issue is whether the existing rules for asset purchase treatment of an acquired subsidiary should be revised.

Bill provisions

Section 201 of the bill would replace the provision of existing law with an election treating a purchased subsidiary as if it had sold all its assets in a 12-month liquidation requiring recognition of recapture items when the qualifying stock purchase occurred (80-percent control). Since, as the "old" corporation, it would be considered terminated on such date, its tax attributes would not be available on the purchasing company's consolidated return.

Generally, the election would apply to all members of an affiliated group after a qualifying purchase of the stock of the parent corporation. A conforming amendment to existing law (section 202 of the bill) would require that all members of an affiliated group be liquidated when any member elects nonrecognition of gain or loss on sales made in the course of a 12-month liquidation. These provisions are designed to restrict selectivity of treatment for particular assets and thereby provide consistent treatment for all assets involved in an acquisition or liquidation.

Effective date

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

b. Toll charge for basis step-up

Statement of problem

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

Bill provisions

Section 203 of the bill would state these two principles as explicit rules of law overriding the provisions of existing law, including the consolidated return regulations, to the extent they otherwise would permit avoidance or deferral of recapture or gain recognition. Current recapture would be required when basis is stepped up to the same extent as though the liquidating corporation sold all its assets in a single transaction to which section 337 applies.

Effective date

The amendments made by section 203 would apply to distributions on or after September 1, 1982.

c. Other areas for Subcommittee consideration

The provisions of the bill (titles I and II) were designed to further the following general principles:

(1) If an acquisition is treated for tax purposes as a purchase of certain assets from an ongoing corporation with continuing tax attributes, gain should be recognized with respect to those assets by the acquired corporation to the same extent as would be required by a direct sale of those assets.

(2) If the acquisition of another corporation is treated as a liquidation of that corporation for tax purposes, recapture items attributable to all assets should be taken into account currently to the same extent as would occur under the generally applicable corporate liquidation rules.

(3) Within the constraints of the two principles above, an acquiring corporation should have the flexibility to treat a corporate acquisition either as a purchase of assets (with the advantages and disadvantages of that treatment) or as a continuation of the acquired corporation (with the advantages and disadvantages of that treatment) but should not be permitted to treat the acquisition aas both (a purchase of some assets and a continuation of tax attributes and basis for other assets).

The bill contains several provisions dealing with affiliated groups of corporations. For example, the provision allowing an election to treat an acquired corporation as having sold its assets pursuant to a plan of liquidation requires consistent application to the affiliates of the acquired corporation. The specific requirements relating to the typical transactions are also backed up by authorizing issuance of regulations to prevent avoidance of the general rule by tax motivated restructuring of a target corporation. Also, broad regulations authority would be granted to carry out the purposes of the proposed toll charge for corporate basis step-ups.

Some may suggest that the bill, or its legislative history, should definitively deal with a variety of transactions and corporate structures to ensure consistent tax treatment. Thus, the Subcommittee may wish to consider providing definitive rules for certain additional cases either as an alternative to the broad delegations of regulations authority or as modifications providing guidance for the implementation of the regulations authority.

Some of the areas the Subcommittee may wish to consider are described below for the convenience of the members and staff.

(1) *Disposition of all assets by distribution of assets and sale of subsidiary.*—If a liquidating corporation distributes directly held assets and sells the stock of a subsidiary corporation to a corporate buyer, the buyer can elect, under the bill, to treat the purchase of the subsidiary as a purchase of assets. Consistent application of the principle that only recapture items should be taxed in a liquidation should require only recapture in such a case since all assets of the former affiliated group would be stepped up and all tax attributes of the former members would be terminated. The Subcommittee may wish to make it clear that this treatment applies to this particular case.

(2) ***Sale of assets and controlled subsidiary to acquiring corporation.***—A corporate seller operating one trade or business directly and a second trade or business through a subsidiary could sell the directly owned business and the stock of the subsidiary to a corporate buyer in the course of a complete liquidation. Unless precluded by regulations to prevent avoidance of the affiliated group rules, such a sale would result in recapture income only being taxed to the seller with respect to the sale of its directly held assets (assuming nonrecognition of gain is afforded the seller under sec. 337) while basis and other tax attributes would be retained by the acquired subsidiary, if the corporate buyer does not elect to treat the stock purchase as a purchase of assets. The Subcommittee may wish to specifically require consistent treatment for all acquired assets, including those held by a subsidiary.

(3) ***Series of acquisitions from same parent corporation.***—A selling corporation could separately sell stock in several subsidiary corporations to a corporate buyer. The bill requires an election treating the purchase of stock of a corporation as an asset purchase to be applied with respect to all corporations acquired as a result of the purchase but does not expressly preclude separate elections where commonly controlled corporations are "brother-sister" corporations or are acquired in separate transactions. The Subcommittee may wish to specifically require a consistent election (or failure to elect) with respect to all members of an affiliated group acquired in separate transactions within a prescribed period of time, e.g., a 5-year period.

(4) ***Sale of assets following a spin-off of other assets.***—The rule requiring gain to be recognized on a liquidating distribution of property when the liquidating corporation has contributed property to a subsidiary within 5 years (or when a spun-off subsidiary is liquidated) could be expanded to specifically cover the sale of assets. The liquidating corporation selling assets may have placed trade or business properties to be retained in a subsidiary and distributed the stock in a tax-free distribution to its shareholders in anticipation of the asset sale. In such case, gain may go unrecognized on the assets disposed of pursuant to a 12-month liquidation while the tax attributes and asset basis of the subsidiary are retained. The Subcommittee may wish to extend the gain recognition requirement to the sale of assets whenever there has been a prior spin-off of assets within a prescribed period of time, e.g., 5 years.

Title III—Limitations on Net Operating Loss and Other Carryovers

a. Special limitations on loss and credit carryovers

Present law

Corporations are generally allowed to carry net operating losses and tax credits forward for 15 years. Generally, the net operating loss and credit carryovers of an acquired corporation are not reduced by reason of another corporation's purchase of control of the acquired corporation if the trade or business of the acquired corporation is continued

(sec. 382(a)). In the case of reorganizations, there is a proportionate reduction of loss and credit carryovers whenever the shareholders of the acquired loss corporation have less than a 20-percent continuing interest in the acquiring corporation as a result of the reorganization (sec. 382(b)). Under a more general provision, carryovers could be denied if the Internal Revenue Service can show that the principal purpose for the acquisition of control of the corporation was the evasion or avoidance of the Federal income tax (sec. 269).

Under the Tax Reform Act of 1976, the rules relating to net operating loss and credit carryovers (sec. 382) were strengthened to deal with "trafficking" in loss corporations. However, in response to widespread criticism primarily relating to complexity Congress has postponed the effective date of the provisions several times. Currently, the 1976 revisions are scheduled to become effective in 1984.

Statement of problem

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

Issue

The issue is whether the provisions of present law should be revised to deal more effectively with trafficking in companies with loss and credit carryforwards.

Bill provisions

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

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

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

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

Effective date

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

b. Reorganizations constituting changes in form

Present law

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

Issue

Should "F" reorganizations be limited to changes in a single operating corporation?

Statement of problem

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

Bill provisions

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

Effective date

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

2. H.R. 5719—Messrs. Harkin, Mitchell of Maryland, Murphy, and Bedell

Excise Tax on Mergers

Present law

Under present law, no special excise tax is imposed with respect to corporate mergers or takeovers. In certain limited circumstances, present law disallows deductions for interest on indebtedness incurred to acquire another corporation.

The tax benefits attributable to trade or business properties are greater generally in the hands of a purchaser than in the hands of the seller. The depreciable or depletable basis of assets is stepped up to reflect the buyer's cost. Also, recapture income and often gain in excess of the recapture amount is taxed to the seller. These adverse tax consequences to a corporate seller often can be eliminated or reduced, particularly where a takeover company purchases the stock of the seller and acquires the assets by a distribution in redemption of some or all of the stock. If the takeover company and the purchased company file consolidated returns, recapture can be deferred as well. In the latter case, considerable discretion is available to select assets for such treatment while retaining any favorable tax attributes of the acquired corporation, which will benefit the takeover company through the consolidated return.

Issue

The issue is whether an excise tax should be imposed to deter mergers and takeovers involving large companies.

Statement of problem

Tax benefits made available to an acquiring corporation may often encourage corporate mergers and takeovers. Mergers between large companies may adversely affect the degree of competitiveness in the economy.

Bill provisions

General rule

The bill would impose an excise tax of 15 percent on certain takeovers by individuals, corporations, partnerships or trusts. The tax would be imposed on the value of the consideration furnished for the acquisition by the acquiring party. In general, the tax would be paid by the acquiring party. Thus, the tax is in effect a toll charge on the ability of the acquiring party to obtain the tax benefits stemming from corporate takeovers.

The tax would apply only if either the acquiring party or the acquired party had receipts exceeding $2 billion for the year prior to the acquisition. Also, the other party must have had gross receipts of over $300 million for the year prior to the acquisition.

For stock acquisitions, the acquiring party must acquire (1) 50 percent of the voting stock of the acquired corporation, or (2) 35 percent of the voting stock if that portion of the stock is worth at least $150 million. For asset acquisitions, the acquiring party must acquire assets having a value at the time of the acquisition of $150 million.

The tax does not apply to the acquisition of a loss company since there are other limitations in the Code on such acquisitions. A loss company is a company with (1) a net operating loss in the year preceding the takeover year of at least 3 percent of the value of the company's assets at the close of the prior year, or (2) an aggregate net operating loss for the four years preceding the takeover year of at least 10 percent of the value of the company's assets at the close of the year prior to the takeover year. In addition, the tax does not apply if the Secretary of the Treasury determines after consultation with the Secretary of Commerce that the acquired party faces substantial foreign competition and the acquisition would significantly improve the ability to compete with foreign companies.

The bill does not specifically allow or disallow income tax deductions for the payment of the excise tax.

Certain foreign acquisitions

For acquisitions by entities controlled directly or indirectly by a foreign government, the tax is increased from 15 percent to 50 percent. Also, if the acquiring entity is a foreign entity and the acquired entity is a domestic entity, the acquired entity must deduct and withhold the tax imposed on the foreign entity.

Effective date

The bill would apply to acquisitions after the date of enactment.

3. H.R. 5517—Mr. Evans of Iowa

Denial of Deduction of Interest on Corporate Acquisition Indebtedness if President Determines Use of Debt for Corporate Acquisitions Should Be Discouraged

Present law

Present law disallows a deduction for interest in excess of $5 million paid or incurred on certain corporate acquisition indebtedness having equity characteristics. Obligations incurred to acquire stock or assets of another corporation are defined as corporate acquisition indebtedness. However, corporate obligations are so defined only if they are subordinated to other claims against the corporation, are either convertible or accompanied by a stock option, and the issuing corporation either has excessive debt or its projected earnings do not exceed three times the interest to be paid or incurred.

Statement of problem

The deductibility of interest on indebtedness incurred to finance corporate takeovers acts to encourage takeover activity at a time when the credit resources of the nation might be used for more productive investment. The restrictions on the definition of corporate acquisition indebtedness under present law do not affect deductibility of interest on indebtedness without equity characteristics.

Issues

The issue is whether deductions for interest on corporate acquisition indebtedness should be disallowed when there is a Presidential determination that monetary policy should discourage uses of credit to finance corporate acquisitions.

Bill provisions

Under the bill, in lieu of the restrictive definition in present law, corporate acquisition indebtedness would include any obligations issued by a corporation to provide consideration for the acquisition of assets or stock of another corporation. The revised definition would apply to obligations issued during the corporate acquisition moratorium period. Such period would commence on the date of publication in the *Federal Register* of a Presidential determination that it is in the national interest that monetary policy should discourage the reservation or use of large blocks of credit to finance the acquisition of stock or assets of other corporations. The corporate acquisition moratorium period would expire 2 years after publication of the determination or, if earlier, the date of publication in the *Federal Register* of a Presidential determination that the period should terminate.

Effective date

The amendment would apply to obligations issued after the date of enactment.

4. H.R. 4562—Mr. Dorgan, et al.; and H.R. 5855—Mr. Stark

Denial of Deduction for Interest on Loans in Connection With an Unfriendly Takeover, or Attempted Takeover, of a Corporation

Present law

Present law has a rule of limited applicability that disallows the deduction for interest exceeding $5 million a year on certain corporate acquisition indebtedness. Such indebtedness is limited to obligations which, under prescribed statutory standards, have attributes characteristic of stock issues. Subject to such limitations, corporate acquisition indebtedness is indebtedness issued to provide consideration for stock or assets of another corporation.

Statement of problem

The restrictions under existing law on the definition of corporation acquisition indebtedness are ineffective to deter corporate takeover activity financed with normal debt. Further, the $5 million floor does not affect takeover attempts of smaller companies. Both small and large target companies may be unwilling parties to the takeover, a consideration that has no relevance under the restriction of present law.

Issue

The issue is whether deductions for interest or corporate acquisition indebtedness should be disallowed if connected with an unfriendly takeover.

Bill provisions

H.R. 4562 and H.R. 5855 would disallow a deduction for interest on loans, the proceeds of which are used in connection with the acquisition, or tender for acquisition, of stock if the borrower acquires, or is attempting to acquire, control of the target company and a majority of the board of directors of the target company disapprove of the acquisition. The proposal would apply to all debt satisfying these standards and the deduction would be disallowed without regard to the amount of interest paid or incurred.

Effective date

H.R. 4562 would apply to interest paid or incurred after the date of enactment in taxable years ending after such date; and H.R. 5855 would apply to interest paid or incurred after December 31, 1981.

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