

DESCRIPTION OF H. R. 6725

THE CORPORATE TAKEOVER TAX ACT OF 1982

Scheduled for Markup

on July 12, 1982

By the

Subcommittee on Select Revenue Measures

of the

Committee on Ways and Means

Prepared by the Staff

of the

Joint Committee on Taxation

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INTRODUCTION

This document describes H.R. 6725 (Mr. Stark) and other proposals relating to the tax treatment of corporations and shareholders.

H.R. 6725 incorporates the provisions of H.R. 6295 with modifications other than the provisions of Title III of H.R. 6295 relating to limitations on net operating losses and other carryovers. The chief modifications are those requiring consistency of treatment by the purchaser in a corporate takeover in lieu of more comprehensive anti-avoidance rules and the elimination of a requirement that gain or loss be required in certain complete liquidations. In lieu of these provisions, the bill provides broad discretion in the Secretary of the Treasury to deal with transactions that might defeat the purposes of the bill. H.R. 6295 was the subject of a public hearing before the subcommittee on May 24, 1982.

This writeup also has other possible amendments suggested by the Treasury Department.



Summary of Principal Changes Made by H.R. 6725

<u>Subject</u>	<u>Present Law</u>	<u>H.R. 6725</u> ^{1/}
Treatment of corporation distributing property in partial liquidation	Gain or loss not recognized to corporation but recapture rules apply.	Same, if distribution is made without redeeming stock from shareholders. Gain recognized if stock is redeemed.
Treatment of shareholders on partial liquidation	Gain or loss recognized with respect to stock redeemed, generally capital gain or loss	Same only if there is a non-pro rata stock redemption. If stock is redeemed pro rata, or the property is distributed without redeeming stock, generally will be a dividend to shareholders
Nonliquidating redemptions of stock for appreciated property	Gain or loss, generally capital gain or loss, to shareholders if redemption is not pro rata. If pro rata, may be a dividend. Gain but not loss, is recognized to corporation but with several exceptions.	Same, but most exceptions to the requirement that gain is recognized to the corporation would be repealed.
Stock purchase treated as asset purchase	Applies where 80 percent of acquired corporation's stock purchased by purchasing corporation within one year and subsidiary is liquidated. May take up to 5 years after stock purchase to liquidate, but plan to liquidate must be adopted within 2 years of purchase.	Within 75 days after qualifying stock purchase, purchasing corporation may elect to treat transaction as if subsidiary sold all its assets on stock purchase date and is thereafter a new corporation which bought the assets. No actual liquidation required.
Purchase of assets from corporation and purchase concurrently of the selling corporation's stock	If acquired subsidiary is not liquidated under the asset purchase rule, transaction is both an asset purchase and continuation of subsidiary.	Transaction will be treated as wholly an asset purchase, as if election made with respect to purchased subsidiary.

^{1/} Except as indicated changes described correspond to those agreed to by the Senate Finance Committee as announced on July 6, 1982.



Summary of Principal Changes Made by H.R. 6725

<u>Subject</u>	<u>Present Law</u>	<u>H.R. 6725</u>
Purchase of several corporations that are members of the same affiliated group	By complying with asset purchase rules, liquidation of one or more corporations may be treated as asset purchases while continuing one or more other corporations.	Must elect to treat all acquired affiliates as if assets were sold or treat all acquired corporations as continuing.
Purchase of assets from a corporation and purchase of the stock of an affiliated corporation	Asset purchase plus continuation of the acquired subsidiary if it is not liquidated under the asset purchase rules.	Deemed to be entirely a purchase and sale of assets as if election made for acquired subsidiary.
Reorganizations that are mere changes in identity, form, or place of organization	Applies to mergers of several, commonly-owned operating companies.	Confined to the reorganization of a single operating company. <u>2/</u>

The effective date for the changes relating to the treatment of partial liquidations and stock redemptions apply in the case of distributions after August 31, 1982. Changes relating to the treatment of stock purchases as asset purchases apply where the date of acquisition (of 80 percent or more of the acquired corporation's stock) occurs after August 31, 1982. The effective dates of the changes agreed to by the Senate Finance Committee are the same except that the changes relating to the treatment of stock purchases as asset purchases would not apply where there was, on July 1, 1982, either a tender offer outstanding for the target company or a binding contract to acquire the target company.

2/ This change was not agreed to by the Senate Finance Committee.



The Corporate Takeover Tax Act of 1982

Overview

The provisions of H.R. 6725 are intended to accomplish the following objectives:

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

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

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

TITLE I

In general

Title I of the bill requires a corporation that distributes appreciated property in redemption of part of its stock to recognize gain, as it would be required to do if it sold its assets.

Partial Liquidations--Background

Principally Title I affects transactions that qualify as partial liquidations under present law. A distribution of assets by a corporation in redemption of its stock qualifies as a partial liquidation if it results in a significant contraction of the distributing corporation's business operations. There is no gain or loss recognized to the



corporation except for recapture tax with respect to prior depreciation, investment tax credit, and other items. Gain or loss to the shareholders resulting from the exchange of part of their stock for the assets in most cases is capital gain or loss. The fair market value of the distributed assets at the time of distribution becomes the basis to the shareholders.

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

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

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



Proposal

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

Stock Redemptions--Background

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

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

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



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

Proposal

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

General Effect of Title I

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

TITLE II

In general

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

Stock Purchase Treated as Asset Purchase--Background

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

Gain also is not recognized by the liquidating corporation if instead of purchasing the assets directly from the liquidating corporation, a corporate purchaser buys 80 percent or more of the stock of the corporation and then liquidates it. The basis in the assets is stepped up to reflect the purchase price of the stock. In effect, the stock purchase is treated as an asset purchase. However, unlike the rules requiring that sales in liquidation occur within a one-year period, the rules governing



liquidation of a recently purchased subsidiary do not require liquidation until 5 years after the stock acquisition. The acquired subsidiary has two years to adopt a plan of liquidation and three years after adoption of the plan to actually liquidate. During the interim, the acquired corporation is affiliated with its parent and is included on the latter's consolidated return if one is filed. The bases for the subsidiary's assets and its other tax attributes continue. Because of interim earnings, distributions, sales of assets and other items by the acquired corporation between the stock purchase and ultimate liquidation, complex adjustments are required that lead to inappropriate results in some cases. Recapture income of the subsidiary may be offset against losses of the acquiring corporation on a consolidated return, a result unavailable when assets are directly purchased.

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

Proposal

Title II of the bill would replace the present law provision treating a stock purchase as an asset purchase with an election, to be made within 75 days after 80 percent or more of the acquired subsidiary's stock is purchased, to treat the acquired subsidiary as if it sold all its assets in a complete liquidation on the stock purchase date. No actual liquidation would be required. The basis of the assets would be adjusted to reflect the cost of the stock as of the stock purchase date and other tax attributes of the acquired corporation would terminate as of that date. The subsidiary would be treated as a new corporation that purchased the assets and only the



"new" corporation would join in the acquiring corporation's consolidated return. The interim adjustments required under the existing rules treating subsidiary liquidations as asset purchases would not be required.

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

Reorganizations Constituting Changes in Form--Background

A reorganization includes "a mere change in identity, form, or place of organization" (an F reorganization). Generally, present law requires a transferor corporation's taxable year to be closed on the date of a reorganization transfer and precludes a post-reorganization loss from being carried back to a taxable year of the transferor. However, F reorganizations are excluded from these limitations in recognition of the intended scope of such reorganizations as embracing only formal changes in a single operating corporation. Court decisions have permitted certain fusions of several operating companies to qualify as F reorganizations as long as there is sufficient identity of proprietary interest and there is uninterrupted business continuity. The exceptions for F reorganizations from the restrictions on closing the taxable year of a transferor and limiting carrybacks are not appropriate to mergers of several active business corporations.

Proposal

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



Other Proposals Relating to the Treatment of
Corporations and Shareholders

Use of Holding Companies to Bail Out Earnings--Background

Shareholders who have their stock redeemed in a corporate distribution are entitled to sale or exchange treatment rather than a dividend generally only if the transaction results in a substantial reduction in their proportionate interests in the distributing corporation. This distinction between sale or exchange treatment and dividend treatment is important because a sale or exchange may result in capital gains whereas a dividend results in ordinary income to the extent of earnings and profits. Where the same shareholder or a group commonly controls two or more corporations, they may attempt to avoid the dividend consequences that would result from a pro rata redemption of stock by selling the stock in one controlled corporation to another. Present law deals with this effort to avoid dividend treatment by testing the transaction as if the shareholders had their stock redeemed by the corporation whose stock is sold.

Shareholders may avoid the present law rules by borrowing funds secured by the stock of a corporation with earnings and profits and contributing the stock to a newly formed holding company in exchange for the holding company's stock plus its assumption of the liability for the borrowed funds. The transaction literally complies with present law rules governing tax-free incorporation of property. These rules overlap with those requiring stock sales to a commonly controlled corporation to be tested as stock redemptions. The courts are divided as to which provision controls. Even if the redemption rule applies and dividend treatment results, dividend consequences would be determined by reference to the earnings of the purchasing corporation. If it is a newly formed holding company, it would have no earnings (a pre-existing corporation without earnings could also be used).

Another device to bail out earnings is to cause a corporation to issue preferred stock as a nontaxable stock dividend to its shareholders. A sale of the preferred stock at capital gain rates would not dilute the interests of the selling shareholders in future corporate growth while they would receive an amount representing corporate earnings. Preferred stock issued under these circumstances (described as section 306 stock) is tainted under present law so that its subsequent sale or redemption results in ordinary income to the shareholder. This provision does not taint stock of a newly formed corporation issued in a tax-free transaction in exchange for stock in a corporation with earnings and profits. Thus, creation of a holding company issuing both common and preferred stock offers the same bail-out opportunity but does not result in tainted section 306 stock.



Proposal

The subcommittee may wish to extend the anti-bailout rules of present law to the use of holding companies formed to avoid such rules. Such rules would be made applicable to a transaction that otherwise qualifies as a tax-free incorporation of assets.

Assumption of shareholder debt by the holding company would be treated as property received by the transferor shareholders. However, debt incurred to acquire the stock of an operating company would be excepted since assumption of such debt would be an alternative to a debt-financed direct acquisition by the holding company.

To the extent of any amount distributed, liability assumed, or the fair market value of preferred stock issued, the holding company would be treated as the recipient of the earnings and profits of the operating company. The subcommittee may wish to consider a broader rule treating the holding company as having earnings and profits of the operating company proportionate to its stock holding.

In determining whether the corporations are commonly controlled so as to invoke the anti-avoidance rule, all shareholders transferring stock to a holding company should be counted even though some of them do not receive property other than stock.

Application of Attribution Rules--Background

In determining whether a shareholder is entitled to sale or exchange treatment on a stock redemption, stock held by related parties is attributed to the shareholder in determining whether the shareholder's interest in the corporation was terminated or significantly reduced. The attribution rules do not apply to some transactions that are economically equivalent to straight stock redemptions and that offer an equivalent opportunity to bail out earnings. For example, a shareholder may exchange all of his common stock in a corporation for preferred stock. Such an exchange results in tainted, section 306 stock only if, had cash been distributed in lieu of preferred stock, there would have been a dividend. Unless stock held by another family member or controlled entity is attributed to the shareholder, cash in lieu of preferred stock would have terminated the shareholder's interest and not result in a dividend. Also, a shareholder exchanging stock in a reorganization for property other than stock or securities may have dividend consequences if the transaction has the effect of the distribution of a dividend. For this purpose, attribution rules do not apply.



Proposal

The subcommittee may wish to extend the ownership attribution rules to a determination of whether, for section 306, the effect of a transaction is substantially the same as a dividend and in determining whether the receipt of property in a reorganization has the effect of a dividend.

Waiver of Family Attribution--Background

In determining whether a shareholder has completely terminated his interest in a corporation on a stock redemption so as to achieve sale or exchange treatment, present law allows the shareholder to waive attribution of ownership from other family members. The waiving shareholder in general may hold no interest in the corporation (except as a creditor), may not acquire any interest for a 10-year period, and must agree to notify the Internal Revenue Service of any such acquisition. The statute of limitations for the year of redemption remains open in the event of such an acquisition.

Stock may be attributed by family attribution and reattributed to an entity such as an estate or trust in which the constructive owner has a beneficial interest. The Internal Revenue Service takes the position that only an individual may waive family attribution. Several decided cases have held that an entity terminating its interest can waive family attribution from a family member to the beneficiary. These cases do not preclude the beneficiary from acquiring an interest in the corporation, do not require an agreement from the beneficiary, and do not reopen the statute of limitations in the event of an acquisition by the beneficiary. One case has also held that an entity may waive attribution from a beneficiary to the entity.

Proposal

The subcommittee may wish to consider a rule permitting an entity to waive the family attribution rules if those through whom ownership is attributed to the entity join in the waiver. Thus, a trust and its beneficiaries could waive family attribution to the beneficiaries if, after the redemption, neither the trust nor the beneficiaries hold an interest in the corporation, do not acquire such an interest within the 10-year period, and join in the agreement to notify the IRS of any acquisition. The entity and beneficiaries would be jointly and severally liable in the event of an acquisition by any of them within the 10-year period and the statute of limitations would be open to assess any deficiency. The tax increase would be a deficiency in the entity's tax but would be asserted as a deficiency against any beneficiary liable under the rules. The tax would be



triggered only against the beneficiary whose acquisition triggers the deficiency where, because it has insufficient funds or gone out of existence, the tax cannot be collected from the entity.

Only family attribution can be waived under the proposal. The statute would clarify that the agreement will not be effective to waive the entity attribution rules.

Certain anti-avoidance rules of present law would be extended to the entity and affected beneficiaries.

Controlled Group of Corporations--Background

In determining whether a controlled group of corporations is confined to one surtax exemption and for other purposes, a brother-sister controlled group exists where 5 or fewer persons own (1) 80 percent or more of the stock in each corporation and (2) more than 50 percent of the stock in each corporation, counting stock only to the extent of identical ownership in each corporation. Under the regulations, the 80-percent test is satisfied if the same 5 or fewer shareholders singly or in combination own 80 percent of each corporation. For example, if A owns 100 percent of X corporation and 60 percent of Y corporation, and B owns the other 40 percent of Y corporation, a controlled group exists. Identical ownership is 60 percent and the 80-percent test is satisfied because total ownership in both corporations is confined to 5 or fewer shareholders. The Supreme Court in U.S. v. Vogel Fertilizer Co. (January 1, 1982) held the regulation invalid. The Court held that a controlled group did not exist although one shareholder owned 77 percent of one corporation and 87 percent of another. A single shareholder owning the other 23 percent in the first corporation owned none in the second. If the 80-percent test imposes a common ownership requirement, it is not clear that the 50-percent identical ownership requirement has any significant, independent function.

Proposal

The statute could be amended so that the 80-percent test would limit the control group to 5 shareholders but would not impose an 80-percent common ownership requirement.

