[JOINT COMMITTEE PRINT]

FEDERAL INCOME TAX ASPECTS OF MERGERS AND ACQUISITIONS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

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PREPARED BY THE STAFF

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INTRODUCTION

The Subcommittee on Oversight of the Committee on Ways and Means, in conjunction with the Subcommittee on Select Revenue Measures, has scheduled hearings on April 1, 2, and 16, 1985, on Federal income tax aspects of corporate mergers and acquisitions. This pamphlet,* prepared in connection with the hearings, provides a description of many of the relevant Federal income tax considerations.

The first part of the pamphlet contains an overview. The second part generally discusses tax policy issues raised by the applicable and proposed tax rules. Part three describes, in simplified form, common forms of acquisition transactions, and part four contains a more detailed and technical articulation of the applicable tax rules. The fifth part discusses possible changes in some of those rules and suggests other areas that may warrant further examination. An Appendix briefly describes possible technical amendments that might be considered.

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*This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985.

I. OVERVIEW

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

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

[1] Under the Internal Revenue Code, "merger" is a term of art, referring to certain kinds of combinations of 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 of one corporation by another.

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

Table 1.—Mergers and Acquisitions, 1968–84—Continued

[Dollar amounts in billions]

Year	Number of transactions [1]	Value of consideration exchanged [2]	
		Nominal dollars	Constant (1983) dollars
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.

Sources: W.T. Grimm & Company and Council of Economic Advisors.

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 huge takeover contests. 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. 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.[3]

Certain features of the corporate and individual income tax (as well as of the estate and gift tax) may affect the attractiveness of mergers 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.

[3] *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 tactics used in takeover contests, and the corporations that are candidates for becoming acquirors or targets. The organization of this part is as follows: first, the relevant tax rules are summarized; second, the effect of those rules on the form and substance of merger activity is analyzed; third, the policy implications of tax-motivated merger activity are assessed; and fourth, some general proposals for change are evaluated.

A. Summary of Tax Rules

Three features of the Federal income tax appear to have the most significant effect on the pattern of merger activity: (1) the differing tax consequences of acquiring an entire corporation versus acquiring individual corporate assets; (2) the disparate treatment of various forms of corporate "distributions" resulting 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.

1. General provisions of the corporate income tax

Income from corporate assets that is paid to debtholders is not subject to tax at the corporate borrower 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 investment is as high as 73 percent (assuming a 46-percent corporate rate).[4] 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 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 acquisitions effectively in-

[4] 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).

crease 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 corporations escapes corporate income tax as a result of various 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.[5] 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.[6] Thus, there is a tax incentive for structuring mergers which effectively permit more rapid utilization of current preferences and carryforwards.[7]

2. General provisions of the individual income tax

Shareholders are taxed on the income from corporate assets only when distributed as a dividend or when gain is realized from a sale or other disposition of their shares. Thus, shareholders can defer tax on corporate income that is reinvested rather than distributed as a dividend. This may result in large accumulations of undistributed corporate income and attract takeover attempts.[8] 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 capital gains from the sale or other disposition of stock (as a result of the 60 percent capital gain deduction). Consequently, the effective rate of tax on capital gains of individuals is no more than 20 percent. Further, because of the stepup 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.

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[5] A corporation experiencing a real economic loss might 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.

[6] 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.

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

[8] Section 531 (relating to unreasonable accumulations) and other sections seek to limit the accumulation of corporate earnings.

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 that 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 exchange his shares, 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.[9]

4. Income tax treatment of acquisitions

The Code distinguishes among the taxable purchase of corporate stock, the taxable purchase 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.

Control of a corporation's assets can be obtained either by acquiring the assets of 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 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.[10] Even though gain is not generally recognized, 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 a section 338 election. If there is such an election, the target generally is treated as having sold its assets in a section 337 transaction.

Alternatively, the purchase of the 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-

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[9] Section 6161(a)(2) provides for an extension 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.

[10] 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.

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.[11]

Table 2.—Income Tax Treatment of Corporate Acquisitions

Tax consequence	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate income tax				
Recognition of gain/loss.	Yes	No	Deferred	Deferred.
Recapture	Yes	Yes	Deferred	Deferred.
Revaluation of basis.	Yes	Yes	Deferred	Deferred.
Transfer of NOLs[2].	No	No	Yes[3]	Yes.[3]
Individual income tax				
Recognition of gain/loss on exchange of shares for:				
1. Cash	N.A.	Yes	Yes	Yes.
2. Debt	N.A.	Deferred	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 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 or securities solely for stock or securities in the acquiring corporation.[12] By contrast, in

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[11] Under Treas. temp. regs. sec. 5f.338-1(c), a section 338 election need not be made before 60 days after publication of the next set of temporary regulations under section 338.

[12] 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) transfer of assets to controlled corporations; (E) recapitalizations;

Continued

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).

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 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 on the principal amount of the note, even though the target's shareholders recognize gain only as principle is amortized. In this manner, the buyer can 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 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 mergers are often motivated by factors other than tax, Federal tax rules do create a number of opportunities for using mergers as tax planning devices. In this section, four tax planning strategies involving the use of 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 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 both the corporate and shareholder levels.

The consequences of the tax rules can be illustrated by means of two simplified examples involving a corporation with $100 of retained earnings, 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

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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).

$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 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 capital gains.

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 do a liquidating sale under secton 337. Either case would result in $20 of 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	$20	$20	[2] $20
Total tax	50	20	20	20

[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[13], then the appreciation would be taxed at both the corporate and shareholder levels. In that event, the sale would trigger $28 of corporate

[13] This would be the case if the $100 of appreciation were distributed and later, in an unrelated transaction, a $10 liquidating distribution were made.

tax (assuming the asset was a long-term capital 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 $82 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 current tax liablity 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.

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

Tax	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate tax	$28	0	[2] $28.00	[2] $28.00
Shareholder tax	36	$20	14.40	[3] 14.40
Total tax	64	20	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.

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.

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 pursuant to 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 to 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 benefits 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 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 and retains or distributes $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	$1,000.00
Debt	0	500.00
Shareholders' equity	1,000	500.00
Income statement		
Operating income	200	200.00
Interest expense	0	70.00
Taxable income	200	130.00
Income tax	92	59.80
Income often corporate tax	108	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 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) and distributes or retains

$70.20 of after-tax income ($130 less $59.80). Consequently, the return on equity is 14.04 percent ($70.20 divided by $500). 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.[13a]

In summary, the Code encourages leveraged acquisitions to the extent that the managers of target corporations fail to exploit the tax advantages of debt financing. This may occur where managers are more adverse to bankruptcy risk than shareholders because, for example, their careers are jeopardized by bankruptcy. 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.

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.[14]

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.

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 merger where shareholders in a potential target hold stock with substantial appreciation and the merger 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 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 ineffi-

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[13a] More generally, the return on equity rises with increasing debt capitalization so long as the interest rate is less than the pre-tax rate of return on corporate assets.

[14] 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.

ciency not only by encouraging inefficient mergers but also by discouraging efficient asset combinations.

C. Policy Implications of Tax-Motivated Merger Activity

The principal tax policy issues raised by tax-motivated 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 merger or merger tactics.

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.[15] 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.[16] 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.[17]

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.[18] The argument is that firms 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, caution would need to be exercised in order to avoid creating excessive tax barriers to mergers. Forcing recognition of gain in certain corporate acquisitions could result in a

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

[16] See *Annual Report of the Council of Economic Advisors*, (February 1985), Chapter 6. These studies compare the market value of the resulting company with the pre-merger value of both the acquiror and the target.

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

[18] *Annual Report of the Council of Economic Advisors*, (February 1985).

"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 "two-tier" tender 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 two-tier tender offers or greenmail in hostile takeover attempts. The Code encourages debt-financed mergers as a result of the general tax advantage available to the debt financing of corporations and the installment method of reporting gain on shares exchanged for debt. However, section 279 seeks to discourage mergers financed by convertible subordinated debentures, although 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 mergers 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. Some have argued that the difficulties in accurately defining income from capital (e.g., depreciation, adjustment of basis for inflation, and recognition of unrealized capital gains) are so severe that a system which attempts to tax such income will inevitably create distortions such as tax-motivated mergers.[19] On these grounds, it has been argued that the only complete solution is to replace the current income tax with a consumption tax, such as the cashflow tax described by the Treasury Department in a 1977 study or a European style value-added tax.[20]

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[19] See for example, Avinash Dixit, "Tax Reform as Industrial Policy," Princeton University, (December 1984).

[20] Dept. of the Treasury, *Blueprints for Basic Tax Reform,* (January 17, 1977). A related proposal is discussed in Robert Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax,* (1983).

The Treasury Department's recent tax reform proposal examines these issues in great detail. The Treasury proposal rejects adoption of a consumption tax and, instead, recommends comprehensive changes in the income tax which would, *inter alia*, more accurately measure income (especially during periods of high inflation), relieve double taxation of dividends, and eliminate tax preferences.[21] These provisions would greatly limit the usefulness of mergers as a tax planning device for distributing corporate income, churning depreciable property, increasing debt financing, and transferring tax benefits.

A substantial reduction in mergers motivated, at least in part, by tax considerations might also be achieved by a reform of the income tax provisions specifically relating to mergers. A proposal to reform the taxation of corporations, published by the Senate Finance Committee staff in 1983, contains a number of provisions which might reduce tax incentives for mergers.[22] The most significant of these, in an acquisition context, are the repeal of the *General Utilities* doctrine and related rules and the imposition of new limitations on the use of loss and credit carryovers by an acquiring corporation. Specifically, this proposal would likely reduce the use of mergers as devices for distributing corporate income and transferring tax benefits. However, the proposals would not affect the use of mergers to increase debt financing. The proposals would also provide elective carryover treatment to avoid creating a "lock-in" effect that might discourage economically sound mergers. It would also generally provide nonrecognition treatment for the receipt of stock by any target shareholder as a part of an acquisition.

Congress has, in the past, considered proposals to relieve or eliminate the double taxation of corporate dividends. Complete corporate integration, such as the proposal discussed in the the 1977 Treasury Study, could eliminate many tax-motivated mergers. In Western Europe, where merger and acquisition activity is a small fraction of that in the U.S., most countries provide substantial relief from double taxation.

A more limited proposal would be to repeal the installment method of reporting (sec. 453), which allows the deferral of tax on gain when shareholders in the target exchange their stock for readily nontradable term debt. The recognition of gain might be required to the extent that the buyer takes a step-up in basis.

Recently, bills have been introduced which would deny interest deductions on a broader class of debt incurred to finance the acquisition of corporate stock or assets and impose tax penalties on payments of certain targeted share repurchases ("greenmail"). While these proposals address the most glaring symptoms of the current merger boom, they do not directly address a number of the root causes of tax-motivated mergers. This raises the question of whether tax-motivated 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.

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[21] Dept. of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, 3 vols., (November 1984).

[22] Staff of the Senate Committee on Finance, *Tax Reform and Simplification of the Income Taxation of Corporations*, S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983).

In conclusion, proposals for change range from comprehensive tax reform to legislation designed to discourage specific takeover tactics. (See generally part five.)

III. THE ACQUISITION TRANSACTION SIMPLFIED: THE FEDERAL INCOME TAX PERSPECTIVE

This part describes the tax profiles of various potential acquired corporations and various potential acquiring corporations or 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. 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, and other legal and personal concerns, among other considerations, are frequently as important, if not 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 affect the price at which it is carried out although there are instances in which the availability of tax benefits is uncertain. In such a case, the buyer will generally not pay much for them. To the extent they turn out to be available, the buyer will have obtained a windfall.

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 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 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. 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 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. Immediately after the acquisition, M will merge into MM. 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. 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 shareholder, 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, A 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 in his B stock, and no tax would ever have been imposed on the appreciation in X's stock.)

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.

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 would in the normal course of its business 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.[23]

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 nonreadily tradable term installment obligations, bearing a market rate of interest, for the C assets (followed by a section 337 liquidation) 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, 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 very 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 step-up. The tax cost of that ordinary income would exceed the present value of the basis step up for the E assets. Therefore, F 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 reorgani-

[23] 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. Suppose further that 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.

zation 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. 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 predating 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 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. 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.

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. The buying company would deduct its interest expenses, thus reducing its (and M's) Federal income tax liability 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. 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, and N's employees desire to buy it. Accordingly, N can set up an employee stock ownership plan ("ESOP") for its employees. N may 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 on and pledges of N's assets. N can then reloan the loan proceeds to the ESOP on substantially the same terms on which it borrowed them. The ESOP can then use the loan proceeds to buy 80 percent of the N stock from Z. The ESOP will pay off the loan with contributions made to it by N in subsequent years. Z will 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 the entire $60 per share, and the investor group's corporation will probably claim that its profit qualifies as capital gain. Second, O may search around for a "white knight". If O is successful, it may find a white knight who will buy 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 would assist O in fending off the acquisition attempt because the ESOP would likely be 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 illustrated the application of those rules in the context of simplified cases. This part discusses, on a more detailed and technical level, many of the operative rules. As indicated in parts two and three, most acquisitions can, from a tax standpoint, be carried out as taxable purchases of assets, as taxable purchases of stock (with or without a secton 338 election), or as tax-free reorganizations. The tax consequences of the 3 differ greatly.

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).[24] The acquiring corporation takes a

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

cost basis for 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 or 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 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. However, 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 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 [25]). 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

[25] 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 interest 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 distributons 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 is 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 puchase, the acquirer can more easily and deliberately assess the wisdom of a section 338 election. In the liquidating sale case, there is no decision to be made—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 a stepup depends, in part, on the nature of the acquired corporation's assets. For example, because land 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 stepup 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 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 be 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 (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).[26] 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 be 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

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[26] 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).[27] 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 against the acquired corporation's post-acquisition income. Conversely, losses realized 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.

In addition to the special limitations on NOL carryovers in section 382, under the "separate return limitation 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" 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, the SRLY rules can frequently be avoided by diverting income-producing activities (or

[27] 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 stepups only with respect to selected assets where a stepup 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 stepup 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" stepups, e.g., the consistency rules of section 338.

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 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. 332 and 336), and the distributee corporation takes a carryover basis in the assets received on 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 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 no 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 stepup—recapture income 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 stepup 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, stepup and recapture will occur only if the parties so elect. Further, the law gives the parties 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	Purchase price	Recapture income	Recapture 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 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 would 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 affordable 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 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 would 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 approximately $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 six 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 respect 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.[28]

If the acquired corporation could be expected to generate $750,000 of pre-tax income in each of the next six years, and the built-in depreciation deductions are allowed in full, the deductions would yield a tax saving of approximately $345,000 each year (46 percent of $750,000), resulting in an after-tax rate of return 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 be $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

[28] 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.

$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).

Because the acquired corporation's post-acquisition income in the 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.

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.

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 four 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 (a type "C" reorganization); 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 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 defined as 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.[29] In the transaction, the acquired corporation 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 reorganization, 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, al-

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[29] 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).

though 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, 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 representing control 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)). 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 bankruptcy 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)). 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 that 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 original appreciation in the acquired corporation's stock can escape taxation entirely if the shareholder holds the qualified consideration until death. In that case, the basis of the stock or securities 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 distinguishing 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.[30] 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 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 (or 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 generally is provided if a subsidiary corporation issues 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 received in connection with 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 "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

[30] 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).

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 annual taxable income of $1 million for each of the next 5 years. Also 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 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 discussed below, 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.[31]

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 the general public, generally will not be deductible by the acquiring corporation. Moreover, these distributions will generate ordinary dividend income to individual

[31] 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.

[32] Footnote eliminated.

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

Subject to certain limitations,[33] 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 principle are tax-free.[34] (Of course, repayments of principle 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).[35]

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[33] 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 three times annual interest costs.

[34] 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).

[35] Some corporations which have sufficient earnings to pay dividends under applicable state corporate law for one reason or another may 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. 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 holder of the preferred 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.

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, thus increasing its attractiveness as a takeover candidate. In addition, similar benefits may provide a large portion of the debt service costs incurred 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 offset 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 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.[36] This debt may be represented by an installment note, in which case the aggregate tax benefits available to the parties may be magnified even further. Under section 453, gain on an installment sale may be deferred and recognized by the seller as payments of principle 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 gains), 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. 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 in-

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[36] The principal amount may be adjusted downward if the debt instrument bears inadequate interest (see secs. 483 and 1274).

stallment note with a face amount and a fair market value of $1 million. The note bears interest at an annual rate of 13 percent,[37] 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 proceeds 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) if 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 stepup 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 can 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,[38] 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

[37] Assume that this rate is adequate for purposes of section 1274.

[38] 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.

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 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, 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 is possible that the target companies failed to take account of the value of assets in the qualified pension plan in setting a purchase price.

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 bankroll efforts to thwart a hostile takeover attempt. This can be accomplished in one of two ways. First, the company can invest the excess assets in plant and 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 (ESOP) funded with the excess assets.

Employee stock ownership plans

An ESOP is a part of a stock bonus or money purchase pension plan that invests primarily in the securities of the employer. ESOPs are accorded preferential tax treatment under the Code as an incentive to participation by employees in their employer. Thus, ESOPs are exempt from tax under the rules generally applicable to qualified pension 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 principle 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 received with respect to any loan the proceeds of which are used by an ESOP to purchase employer securities.

A leveraged ESOP can be used by an employer as a financing tool to obtain funds for working capital, plant expansion, or other purposes. Often this funding method results in a much 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.[39] 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.[40]

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. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company. Again, the employer's contributions to the leveraged ESOP to enable it to amortize the loan will be deductible. In

[39] 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—as low as 80 percent of the existing prime rate—than it lends to its regular customers.

[40] 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.

this manner, the corporation will have significantly reduced 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 loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.[41]

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 generally can be expected to be voted to keep the company independent. Proceeds of the sale are generally available for any purpose, including the payment of greenmail. 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 an ESOP is not immediately credited to employees' individual accounts but is held in a suspense account and released for allocation to employee accounts only as the loan is repaid with employer contributions. During this period, the shares may be voted by plan trustees appointed by management. Furthermore, in some cases the shares sold to the ESOP have more limited voting rights than are normally granted to shareholders of public companies. Thus, the employees' ability to control policy and management decisions may be limited.

Leveraged ESOPs have also been used to accomplish leveraged buy-outs by company managers desiring to "take the company private", that is, to remove it from public ownership.

An incidental effect of leveraged ESOP financing of an acquisition is that the equity interests of the employer's pre-acquisition shareholders may be diluted. This dilution may occur as well, however, in any equity financing arrangement, including a merger with another corporation in which stock of the surviving corporation is issued to the former shareholders of the target.

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 pen-

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[41] 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.

sion 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, 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 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. Any interest paid on the acquisition indebtedness is 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 or section 338 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.

In addition, certain nontax considerations (e.g., securities laws) may make a partnership preferable to a corporation as an acquisition vehicle.

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 or 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 TAX RULES APPLICABLE TO MERGERS AND ACQUISITIONS

Some of the Federal income tax rules described above may be responsible, in whole or in part, for the recent surge in merger and acquisition, and attempted merger and acquisition, activity. The following changes, among others, in the applicable tax rules might be considered. Several of the suggestions (e.g., those relating to installment sales) would have ramifications well beyond the merger and acquisition area and would need to be considered in that light. Other of the suggestions are more limited.

Mandatory asset acquisition

In many respects, the taxable acquisition of a substantial, controlling stock interest in an acquired corporation is the acquisition of the assets of that corporation. The acquiring corporation indirectly gains control of those assets, and it may obtain direct control of them.

One possible change would be to require the acquisition of a controlling stock interest in a corporation in a taxable transaction to be treated as an acquisition of the assets of the acquired corporation rather than as an acquisition of its stock. One result would be to require the acquired corporation to recognize gain (or loss) with respect to its assets. This required recognition might be limited to present-law recapture items or it might be expanded (in which case a change in the rules relating to liquidating sales of assets and in-kind liquidations would also be appropriate). Another result would be to require the acquiring corporation to take a cost basis in all those assets, be it a "stepped-up" or "stepped-down" basis. A third result would be to prevent the acquiring group from succeeding to any tax attributes (e.g., net operating loss carryovers) of the acquired company.

Present law, which provides the parties with an election to achieve the results indicated, may be viewed as unduly generous. However, changing the rules in the manner proposed would tend to reduce the price at which shareholders of some acquired corporations could sell their stock and might inhibit the consummation of what would have been an efficient acquisition.

H.R. 1003 (Mr. Jones) and S. 632 (Sen. Chafee) would both require a target corporation to recognize all gain as though it had disposed of all its assets in the normal course of its business. The rule would apply in the case of a qualified stock purchase (as defined under present law section 338), but only if the acquisition was a "hostile" acquisition.

Effect of election to treat a stock acquisition as an asset acquisition

Alternatively, the law could be changed to modify the Federal income tax consequences of electing under present law to treat a qualifying stock acquisition as an asset acquisition (with appropriate conforming changes). For example, one consequence of such an election could be full recognition of all gain (or loss) with respect to the acquired company's assets. Present law permits the acquirer to step up to fair market value the basis of all the assets of the acquired company but does not require the acquired company to recognize as taxable income any appreciation in the value of its assets (except for recapture items). This result is inconsistent with a pure two-tier tax system and differs from what would have happened had the acquired company not been acquired.

More narrowly, the recapture rules applicable under present law in the case of an election could be tightened. For example, the acquired company could be required to recognize all gain or loss on property which if sold by it outside of an acquisition context would have generated ordinary income or loss (e.g., all inventory, including FIFO inventory). Gain on all section 1250 property (certain real property) could be required to be included in income, as ordinary income or capital gain, to the extent of prior depreciation deductions allowed. This would tend to conform the section 1250 rules with those of section 1245 (relating to personal property and certain real property). Gain on all mineral property could be required to be included in income to the extent of prior intangible drilling costs with respect to such property which were deducted, regardless of whether they were deducted before or after January 1, 1976, or whether the deductions exceeded what could have been recovered through depletion deductions had they been capitalized. Finally, gain on all mineral property could be required to be included in income to the extent of prior depletion deductions allowed, or, alternatively, to the extent percentage depletion deductions allowed with respect to such property exceeded those that would have been allowed under cost depletion.

It has been argued that there is little justification for permitting an acquired corporation to avoid being taxed on the value of its ordinary income assets in excess of their basis. As for tightening the recapture rules, the acquired corporation, in claiming depreciation and depletion, became entitled to tax benefits. Appropriate recapture rules, it is argued, would do nothing more than require an acquired company to return those tax benefits to the Federal government at the appropriate occasion.

In 1983, the staff of the Senate Finance Committee published a report entitled "The Reform and Simplification of the Income Taxation of Corporations".[42] The report contains numerous proposals to revise the treatment of shareholders and corporations. Perhaps its most significant proposal with respect to acquisitions would be a proposal requiring the recognition of all gain by a target corporation on liquidating sales and liquidating distributions and other taxable acquisitions of a target's stock or assets. The deterrent effect that such treatment might otherwise have on acquisitions would be ameliorated to some extent by permitting acquiring corporations to elect to preserve the target's basis for its assets and tax history without recognition of gain (i.e., tax-free treatment), re-

[42] S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983).

gardless of the nature of the consideration furnished by the acquirer. Furthermore, under the proposal, some relief might be provided to shareholders of the acquired company to adjust for tax liabilities of the acquired company that the basic proposal would generate.

Both H.R. 1003 and S. 632 would, as indicated, treat the acquired corporation in a hostile stock acquisition transaction as engaging in a fully-taxable transaction, i.e., without any section 337 relief. Moreover, S. 632 would not permit the acquirer to treat as part of its purchase price (or as part of the basis of the assets deemed acquired) tax liability of the acquired corporation attributable to the deemed sale.

Net operating loss carryovers

It appears to be the case that net operating loss carryovers of either the acquired or the acquiring corporation play an important role in some mergers and acquisitions. In considering what changes, technical or otherwise, should be made to present-law section 382, Congress may wish to consider whether the current rules are too generous.

Interest expense

Because interest is deductible and dividends are not, present Code rules clearly provide a strong tax incentive for corporations to finance themselves with substantial debt capital. While the impact of the rules is certainly not limited to the acquisition context, the income tax law frequently motivates acquisitions by permitting taxpayers to deduct currently interest paid or accrued on debt (including installment debt) incurred in connection with an acquisition. Many acquirers (and acquired companies) are in a position to use those interest deductions to offset income that would otherwise be taxable at a rate at or near 46 percent. (Meanwhile, the lender (which may be a foreign person, a tax-exempt entity, an insurance company, or a domestic financial institution) may not be taxable at a 46 percent rate, or at all, on the interest income.)

While from a tax standpoint many corporations would be well-advised to leverage their capital structures to the maximum extent possible, there are non-tax reasons to resist that pressure. Chief among them, perhaps, is the general notion that the higher a corporation's debt-equity ratio is, the more precarious will its long-term financial position be. This, for example, if the company's fortunes take a downturn, it may be unable to generate sufficient cash to enable it to service its debts. If so, its lenders may be forced to foreclose on the debt, with unpredictable results for the company, its employees, its customers, and the communities in which it has a significant presence. Thus, a corporation which increases its debt-to-equity ratio to fend off an unfriendly takeover attempt may be jeopardizing the future of those interested in its well-being.

A possibility for change would be to disallow deductions with respect to interest paid or accrued on debt (including installment debt) incurred in connection with the acquisition of a company. A similar possibility would be to disallow deductions for interest paid or accrued in connection with a hostile stock acquisition. H.R. 1003 and S. 632 would do this (although the rule of H.R. 1003 would not apply if the purchaser is a corporation). Such a rule, if it could be implemented properly, would take pressure off companies that did not want to be acquired but were unwilling to significantly increase their debt burden. Alternatively, the deduction may be disallowed only for interest paid or incurred on "junk" bonds. (See H.R. 1100 (Mr. Jones).) "Junk" bonds, as defined in that bill, are debt obligations which, under general Code rules, look very much like equity and perhaps should be treated by the issuer as equity. The junk bond proposals should be compared to present-law section 279. That section also disallows the deduction of interest on certain kinds of nominal debt instruments which have significant equity characteristics.

The recent Treasury Department proposal (November 1984) would allow a corporation to deduct 50 percent of the dividends it pays. Such a rule would reduce the potential double tax burden on corporate earnings to a tax of not more than 150 percent of such earnings. The extent to which this rule would affect acquisition activity is conjectural, but, to the extent the relative tax cost of operation in corporate form was lessened, any undervaluation of corporate assets reflected in the market price of stock which is attributable to double taxation may be reduced. Furthermore, the Treasury proposal would also have the salutary effect of reducing the tax incentives for capitalizing a corporation with debt rather than equity. Similar results might follow from the Treasury's proposal to index interest expense and income.

On a related but different point, another possibility for change would be to correct the rules to require, in appropriate cases, that interest paid or accrued by a member of a consolidated return group on debt incurred in connection with an acquisition (or any other debt) be allocated between domestic and foreign sources on a group basis. This rule might prevent an acquiring corporation from being able to allocate interest expenses away from foreign sources merely because the acquiring corporation uses subsidiaries rather than divisions to conduct business abroad. The Treasury proposal advocates such a rule.

Installment sales

Under present law, the acquiring corporation can use installment obligations to make an acquisition. Under the installment sale rules, the sellers frequently defer recognition of gain, recognizing it only as principal payments on the installment obligations are received. On the other hand, the acquiring corporation gets a new basis in the acquired property equal to the total amount of principal payments to be made over time. Particularly if the transaction is an asset purchase (or a stock purchased which the acquiring corporation elects to treat as an acquisition of assets), that basis may produce short-term tax deductions for the acquiring corporation.

This mismatching of gain and deduction, which may be offset to some extent by recapture, might be corrected. One possibility would be to give the acquiring corporation the benefits of a new tax basis only if and as principal payments on the installment obligations are made.

Another possibility would be to require the holder of an installment obligation to pay interest on the "interest-free loan" from the government contemplated by present-law section 453. In addition, the law might be amended to provide that deferral of gain recognition would cease when its holder borrows against it. The recent Treasury Department proposals support that last suggestion.

ESOPs and overfunded pension plans

The role of ESOPs and overfunded pension plans in the merger and acquisition context could be studied and changed where and as appropriate.

"Greenmail"

The 1984 Act imposed significant tax burdens on parties to certain golden parachute contracts and similar arrangements. H.R. 1100 would impose an excise tax of 50 percent on all "greenmail" profits, as defined by the bill. Under S. 632 (Senator Chafee), it would be made clear that no deduction would be allowed for greenmail payments.

Other

The Appendix suggests some additional technical changes in the merger and acquisition rules, and related rules, which Congress might consider.

APPENDIX

ADDITIONAL POSSIBLE CHANGES OF A TECHNICAL CHARACTER RELATING TO THE TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS

1. Return-of-capital distributions

Present Law

In general, the amount of a distribution by a corporation to a shareholder is includible in the shareholder's gross income as a dividend (taxable at ordinary income rates) to the extent the distribution is made out of the corporation's earnings and profits. If the distribution exceeds the corporation's earnings and profits, the balance is applied against and reduces the basis of the shareholder's stock. To the extent the distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of property.

Possible Change

In the case of a distribution that exceeds the distributing corporation's earnings and profits, consideration could be given to treating the distribution as a proportionate sale of the underlying stock.

2. Pre-acquisition dividend strips

Present Law

A corporate shareholder is generally permitted to deduct 85 percent of the amount of dividends received from domestic corporations. Because the maximum rate of tax on income received by a corporation is 46 percent, the maximum tax on dividends received by a corporation is only 6.9 percent. Thus, corporate shareholders of an acquired corporation have an incentive to realize the corporation's earnings in the form of dividends rather than as capital gain on a sale of stock. Toward this end, preparatory to an acquisition, corporate shareholders may in some cases attempt to cause the acquired corporation to distribute earnings that are taxable as dividends, resulting in a reduction in the sale price of the stock and hence in capital gain. Compare *Waterman Steamship Corporation* v. *Commissioner,* 430 F.2d 1185 (9th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (a susidiary's distribution of a short-term note, which was paid off by the acquiring corporation after it obtained control, was recharacterized as a payment for stock in the subsidiary), with *TSN Liquidating Corporation* v. *United States,* 624 F.2d 1328 (5th Cir. 1980) (where the corporate shareholder of the acquired corporation succeeded in establishing that a pre-acquisition dividend was not disguised consideration for a sale of stock). See also Rev. Rul. 75-493, 1975-2 C.B.

Possible Proposal

Dividend distributions to corporate shareholders before a stock sale could in precribed cases be treated as additional sales price.

3. Redemptions through use of related corporations

Present Law

Section 304 was designed to prevent shareholders from drawing off a corporation's accumulated earnings and profits at capital gain rates through the device of having a related corporation purchase stock held by the controlling shareholders. The application of section 304 to noncorporate shareholders could result in the treatment of what would be long-term capital gain (taxable at a maximum rate of 20 percent) as dividend income (taxable at a maximum rate of 50 percent). In contrast, corporate shareholders benefit from the transmutation of long-term capital gain (generally taxed at a maximum rate of 28 percent) into tax-favored dividend income (generally taxed at a maximum rate of 6.9 percent).

Possible Change

Consideration could be given to making section 304 inapplicable to the transfer of stock by corporate shareholders. The tax results under section 304 could also be more closely conformed to those under section 368(a)(1)(D).

4. Section 351

Present Law

Section 351 provides nonrecognition treatment if one or more shareholders transfer appreciated property to a corporation in exchange for stock in such corporation, and, immediately after the exchange, such persons are in control of the corporation. In one widely-publicized transaction, the minority shareholder of an acquired corporation obtained tax-free treatment under section 351 on the receipt of stock, in the context of a larger acquisitive transaction in which the acquiring corporation obtained a cost basis for the controlling stock interest in the acquired corporation (setting the stage for a liquidation that could have stepped up the basis of the acquired corporation's assets under the predecessor of section 338). The Internal Revenue Service ruled publicly that a purported section 351 exchange that is an integral part of a larger acquisitive transactive must satisfy the continuity of interest doctrine (see Rev. Rul. 80–284, 1980–2 C.B. 117). This ruling was revoked in 1984 (see Rev. Rul. 84–71, 1984–1 C.B. 106).

Possible Change

It may be advisable to provide statutory authority for the integration of a section 351 exchange and a related taxable purchase of an acquired corporation's stock. Changes to harmonize the tax results in section 351 transactions and tax-free reorganizations may also be appropriate.

5. Dividend-within-gain limitation in boot dividends

Present Law

The amount of dividend income recognized by an exchanging shareholder on the receipt of nonqualifying consideration in a reorganization cannot exceed the amount of gain.

Possible Change

Consideration could be given to repealing the rule that treats boot as a dividend only to the extent of gain.

6. Treatment of exchanging security holders in reorganizations

Present Law

If a security holder exchanges debt instruments in a reorganization, the new debt instruments are treated as qualified consideration unless the principal amount of securities received exceeds the principal amount of the securities surrendered. Given time value issues, basing tax, consequences on "principal amount" is distortive.

Possible Change

The amount of nonqualifying consideration received by an exchanging security holder could be measured by the difference between the adjusted basis of securities surrendered and the issue price of securities received.

7. Coordination of sections 357 and 361; amendment of sections 311 and 337

Present Law

In general, no gain is recognized by an acquired corporation whose liabilities are assumed by an acquiring corporation in connection with a tax-free reorganization. Nevertheless, if the acquired corporation uses consideration received from the acquiring corporation to pay off its liabilities, the acquired corporation may be treated as realizing taxable gain. See generally *Minnesota Tea Company* v. *Helvering,* 302 U.S. 609 (1938) (under which an acquired corporation's distribution of boot to a creditor was not treated as a distribution "in pursuance of the plan of reorganization" for purposes of the nonrecognition rules of section 361(b); and *FEC Liquidating Corporation* v. *United States,* 548 F.2d 924 (Ct. Cl. 1977) (the application of which would also deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor). But see *General Housewares Corporation* v. *United States,* 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 can apply where the acquired corporation sold part of the stock received as consideration for its assets in a C reorganization and used the sale proceeds to pay debts).

Possible Change

Subject to existing restrictions in section 357 (b) and (c), section 361 could be amended to prevent the recognition of gain by an acquired corporation that uses consideration received in a tax-free reorganization to pay off debts but otherwise to tax it on sales of assets (or the distribution of property not transferred to the acquirer) in the context of a reorganization.

8. Depreciation recapture is certain tax-free exchanges

Present Law

Under present law, a taxpayer can effectively assign ordinary recapture income to another taxpayer by transferring depreciable property in a tax-free exchange. For example, section 1245(b) provides an exception to the recapture rule for depreciable personal property where the property is transferred in a section 351 exchange. Similarly, an acquired corporation recognizes no recapture income if it transfers depreciable assets in a C or A reorganization. If depreciable property is transferred to a corporation that has net operating losses, for example, no tax may be imposed on the recapture income.

Possible Change

Consideration could be given to applying the recapture rules generally when an asset is no longer accounted for on the return that benefitted from the previously-claimed deductions. Thus, there generally would be recapture in all otherwise tax-free acquisitive reorganizations as well as when a subsidiary is no longer included in the consolidated return of the affiliated group that claimed the deduction. In a section 351 exchange, the shareholder's stock might be tainted so that ordinary income would result on disposition of the stock to the extent of recapture income at the time of the section 351 transfer (with a corresponding basis adjustment to the corporation when the shareholder is taxed).

9. Acquisition of small enterprises by large publicly-held corporations

Present Law

Under present law, the exchange of stock in a small enterprise for marketable stock in a publicly-held corporation can qualify for tax-free treatment, even though the effect of the exchange resembles a liquidation of the shareholder's interest in the old corporation. Furthermore, some reorganization forms permit the use of nonvoting stock or preferred stock.

Possible Change

Consideration could be given to denying reorganization treatment to any transaction in which less than 20 percent of the outstanding stock of the acquiring corporation is received by the acquired corporation's shareholders (i.e., a transaction where the acquiring corporation is more than four times larger than the acquired corporation). Such a transaction would be taxed at the corporate and the shareholder level. Furthermore, the use of voting common stock could be required in all reorganization forms.

10. Conversion of a C corporation to an S corporation

Present Law

In general, an S corporation is not subject to tax but is treated as a conduit, similar to the treatment of partnerships. Thus, shareholders who elect to treat their existing closely-held corporation as an S corporation effect a material change in the tax character of their investment. Nevertheless, the conversion of a C corporation to an S corporation is not a taxable event.

Possible Change

An election to convert C corporations to S corporations, or certain acquisitions by S corporations of C corporations, could be treated as taxable events, at least with respect to recapture income.

11. Use of shell corporations to convert short-term capital gain into long-term capital gain

Present Law

In general, gain on the sale of stock that is a capital asset held for more than 6 months is taxed as long-term capital gain, at rates that are more favorable than those applicable to short-term capital gain. If an acquiring corporation or an investor purchases and sells stock of another corporation through a holding company the stock of which has been held for more than 6 months, it may recognize long-term capital gain, even if the holding company's only significant asset is that stock and even if that stock has not been held for the period required for long-term capital gain treatment.

Possible Change

Consideration could be given to looking through a corporation whose stock is sold for purposes of determining whether the applicable holding period is satisfied. This rule could apply to closely-held corporations substantially all of whose assets (excluding cash and marketable securities) consist of recently-acquired property.

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