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An investigation of proposed changes in the federal income taxation of acquisitive reorganizations

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DISSERTATION

Ronald Earl Flinn

The Graduate School
University of Kentucky
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AN INVESTIGATION OF PROPOSED CHANGES IN THE FEDERAL INCOME TAXATION OF ACQUISITIVE REORGANIZATIONS

DISSERTATION

A dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of Business Administration at The University of Kentucky

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ABSTRACT OF

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AN INVESTIGATION OF PROPOSED CHANGES IN THE FEDERAL INCOME TAXATION OF ACQUISITIVE REORGANIZATIONS

This Study investigated four major changes proposed in the still unenacted Subchapter C Revision Act of 1985 for the federal income taxation of tax-free acquisitive reorganizations as defined in the Internal Revenue Codes of 1954 and 1986. Advocates of the Act assert that the proposed changes will simplify and rationalize the federal income tax law. Opponents of the Act argue that: (1) the proposed changes deviate significantly from long-standing notions of realization and recognition of gain and loss in the context of tax-free acquisitive reorganizations; (2) the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 addressed the most significant abuses and lack of symmetry between gain recognition by a target corporation and tax basis of assets in the hands of an acquiring corporation; (3) enactment of the Subchapter C Revision Act of 1985 will cause a major loss of tax revenue to the federal government; and (4) the explicitly elective taxing regime will neither simplify nor rationalize the federal income tax laws. Although the major changes proposed for tax-free acquisitive reorganizations make a great deal of sense from a tax policy perspective, this Study concluded that the Subchapter C Revision Act now has a very small chance of being enacted by Congress. The virtual certainty that the changes would cause the loss of large amounts of revenue assures their nonenactment in today's deficit-driven policy-making environment.

Ronald E. Flinn

Ronald Earl Flinn

December 1, 1989

Date

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Chapter I: Introduction, Statement of the Research Objectives, and Research Questions

Introduction

The related topics of the appropriate role of the federal government in corporate takeovers,/1/ the financial and economic consequences of acquisitive transactions,/2/ the social and political consequences of mergers and acquisitions,/3/ the largely unexplored ethical issues,/4/ and the conditions which have led to the unprecedented volume and size of both friendly and hostile acquisitions of large publicly-held corporations in the United States in the 1980s (what many have called the megamerger era),/5/ have recently received much attention in the business press/6/ and from empirical researchers./7/

The wide-spread substitution of debt for corporate equity alleged to have resulted from the megamerger wave in the United States in the 1980s,/8/ from leveraged buyout transactions,/9/ and from the various tax incentives for using debt rather than equity to finance acquisitions and corporate operations/10/ is a matter of increasing concern to Congress./11/ The alleged failures of present generally accepted accounting principles and corporate financial reporting practices to fairly report the results of business combinations, particularly leveraged buyout and other overleveraged transactions,/12/ should be of concern to accountants and financial executives generally./13/

An extensive tax literature/14/ addresses many of the technical and tax policy aspects of the current federal income tax laws applicable to transactions structured as tax-free/15/ acquisitive reorganizations. The tax literature/16/ and documents prepared for various tax-writing and other Congressional committees with responsibility for various aspects of acquisitive transactions/17/ state there are a number of fundamental problems associated with the current tax law applicable to acquisitive transactions, including those structured as tax-free acquisitive reorganizations. The current wave of megamergers and leveraged buyouts in the United States has done much to bring these tax law problems into public view. The continued appropriateness of the current federal income tax law for acquisitive transactions, including those transactions structured as tax-free acquisitive reorganizations, is a matter of intense public debate./18/

The United States Congress has become increasingly concerned that the current federal income tax law applicable to mergers and acquisitions may no longer represent an appropriate tax policy./19/ Congress has held a number of hearings on the need to fundamentally revise the present federal income tax scheme for corporations and their shareholders in the context of comprehensive tax reform efforts/20/ in the United States in the 1980s./21/ Based largely on the results of these hearings, Congress recently proposed a number of fundamental changes in the current federal income tax law for acquisitive transactions, including tax-free acquisitive reorganizations. The proposals are contained in the Subchapter C Revision Act of 1985./22/

The basic motivation for proposing these changes in the federal income taxation of acquisitive transactions stems from the troublesome issues and inconsistencies identified in the tax literature and in detailed studies of the current tax law by the organized tax bar and by the American Institute of Certified Public Accountants./23/ The various Congressional staff organizations which assist Congress in evaluating the continued adequacy of the present tax law and the appropriateness of proposed changes in the tax law have also been influential in documenting the need for fundamental changes in the current law./24/

Because these proposals, if enacted in their present form, would represent a much different federal income tax policy toward mergers and acquisitions and would radically alter the current federal income tax compliance and planning environments for tax-free acquisitive reorganizations, this Study investigates and evaluates four specific changes proposed in the Subchapter C Revision Act of 1985 for acquisitive transactions characterized as tax-free acquisitive reorganizations under current law.

The changes proposed in the Subchapter C Revision Act of 1985 raise a number of very important and interesting tax policy issues for acquisitive transactions. These issues are of concern to both academic and professional people who deal with the various interrelated problems of the federal income taxation of corporations and their shareholders./25/ The enactment of the changes proposed in the Act would also have far-reaching implications for the federal income taxation of corporations and their shareholders due to the highly interrelated nature of Subchapter C of the Internal Revenue Code of 1986. Subchapter C contains Sections 301 through 385 and, as such, contains the basic federal income tax law applicable to corporate distributions, liquidations, formations, and tax-free reorganizations./26/

Brief Description of the Current Federal Income Tax Law Applicable to Tax-Free Acquisitive Reorganizations

The current federal income tax law applicable to tax-free acquisitive reorganizations is a curious mixture of very complex/27/ and allegedly mandatory/28/ statutory provisions, regulations, case law, administrative pronouncements, and institutional factors which have been developed over the years to protect the integrity of the definitional and operative statutory provisions./29/ In order to emphasize the radical nature of the four proposed changes contained by the Subchapter C Revision Act of 1985 which were the principal subject of this Study the current federal income tax law applicable to tax-free acquisitive reorganizations is briefly summarized below.

Overall Philosophy

The reorganization provisions allow deferred recognition of gains realized in certain exchanges of corporate assets, stock, and securities in order not to discourage changes in corporate forms required by business exigencies. The exchanges must occur in one of the particular ways specified in the Code and effect a readjustment of continuing interests in property under modified corporate forms./30/ In order to exclude transactions not intended to benefit from the deferred recognition of realized gains, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the corporate and noncorporate taxpayers involved to the benefit of the exemption from the general rule that all realized gain must be immediately recognized./31/

The statutory definitions of various types of tax-free reorganizations emphasize the form of the transaction, often over its substance./32/ Failure to comply with the precise requirements and underlying assumptions/33/ of the statute may render a transaction taxable./34/ Compliance with the form alone, however, will not necessarily guarantee that the transaction will be treated as a tax-free reorganization by either the Internal Revenue Service or the courts.

In summarizing the present statutory provisions and judicial doctrines applicable to tax-free reorganizations, Freeman has observed:

> . . . this means that the transaction must have a bonafide business purpose other than the avoidance of tax. Further, the shareholders of the acquired corporation must have a substantial continuing equity or proprietary interest in the acquiring corporation. In general, in order for a transaction to constitute a reorganization, there must be a continuity of the business enterprise under a modified corporate form. This means that the acquiring corporation must either continue at least one significant line of the target corporation's historic business or must use in a business a significant portion of the target corporation's historic business assets.
>
> In addition, giving full regard to substance over form analysis, the IRS and the courts will apply one or another of the manifestations of the step transaction doctrine, to the effect that prearranged steps will be collapsed and treated as part of a single transaction, taking into account the period of time between the steps, the intent of the parties, and the interdependency of the steps./35/

As is generally the case for tax-deferred transactions provided for in the Internal Revenue Code, the basis rules will operate to make it difficult, if not impossible, for the corporate and noncorporate taxpayers involved in a "tax-free" acquisitive reorganization to ultimately escape recognition of previously realized gains and losses.

Definitional Sections

The statutory definitions of the various types of transactions which are eligible for tax-free reorganization treatment are contained in Sections 368(a)(1)(A) through (G). The different types of reorganizations are often identified by the letter of the clause preceding their definition./36/ Five types of tax-free acquisitive reorganizations defined in the current law were the subject of this Study. Their current statutory definitions are summarized below./37/

An "A" reorganization is defined as a statutory merger or consolidation. A statutory merger occurs when the acquired corporation/38/ merges into the acquiring corporation/39/ and loses its separate legal existence by operation of the applicable state law(s). A statutory consolidation occurs when two or more existing corporations are merged into a newly formed corporation and lose their separate legal existence by operation of the applicable state law(s). If a transaction constitutes a merger or consolidation under applicable state law,/40/ it can be an "A" reorganization under current federal income tax law if the transaction does not violate the applicable judicial doctrines./41/

A "B" reorganization is defined as a stock-for-stock exchange between the acquiring corporation and the shareholders of the acquired corporation as a result of which the acquired corporation becomes a controlled subsidiary of the acquiring corporation. The acquiring corporation can issue only its voting stock as consideration to the shareholders of the acquired corporation./42/

A "C" reorganization is defined as a stock-for-assets exchange between the acquiring corporation and the acquired corporation in which the acquiring corporation issues its voting stock and possibly a limited amount of other consideration for all or substantially all of the properties of the acquired corporation. Under current law, the acquired corporation generally must undergo a complete liquidation to effect a "C" reorganization./43/

A triangular, subsidiary, or forward "A" reorganization is defined as a transaction in which the acquired corporation is merged into an often newly formed controlled subsidiary of the acquiring corporation which remains in existence. As a result of this transaction, the acquired corporation becomes a controlled subsidiary of the acquiring corporation./44/

A reverse triangular or subsidiary "A" reorganization is defined as a transaction in which an often newly formed controlled subsidiary of the acquiring corporation is merged into the acquired corporation. The controlled subsidiary loses is existence in the transaction. As a result of this transaction, the acquired corporation becomes a controlled subsidiary of the acquiring corporation./45/

Operative Sections

The operative sections of the Code are those which provide the federal income tax consequences of transactions which satisfy the statutory definitions of tax-free reorganizations. The principal operative provisions include sections 354, 355, 356, 357, 358, 361, 362, 381, 382, and 383. An understanding of the operative sections is particularly important because, under current law, the operative provisions are allegedly mandatory rather than elective.

The operative sections determine:

1. whether the transaction is tax-free, i.e., tax deferred, to the corporate and noncorporate parties involved;

2. the federal income tax basis of the acquiring corporation stock or securities received by the acquired corporation, its shareholders, or its security holders; and

3. the federal income tax basis to the acquiring corporation for assets or stock received from the acquired corporation or its shareholders.

Under the operative provisions, gain inherent in the acquired assets or stock, i.e., the gain realized but not immediately recognized by either the acquired corporation, its shareholders, or its security holders, will be recognized by the acquiring corporation upon its ultimate taxable disposition of the assets or stock acquired from the target corporation.

Benefits of Tax-Free Reorganization Treatment

The opportunity to defer recognition of gain realized upon a tax-free acquisitive reorganization has historically been one of the principal motivations for structuring acquisitions as some type of tax-free acquisitive reorganization. Due to the virtual elimination of the complete liquidation provisions contained in the 1954/46/ Code which were based on the General Utilities doctrine,/47/ the elimination of the preferential federal income tax treatment historically given to long-term capital gains for both individual and corporate taxpayers,/48/ and the fact that the 1986 Code makes its clear that the complete liquidation provisions do not apply to the target corporation which undergoes a complete liquidation as part of a tax-free acquisitive reorganization,/49/ the opportunity to defer recognition of gains realized by the target corporation and its shareholders and security holders will be an even more important reason to structure acquisitive transactions as some type of tax-free reorganization under the 1986 Code./50/

Many commentators feel the changes made in the complete liquidation provisions/51/ will also encourage acquisitive transactions to be structured as some type of tax-free reorganization because the present value of the immediate tax costs of a transaction in which the assets of the target corporation obtain a stepped-up basis in the hands of the acquiring corporation, e.g., a taxable sale of assets or a Section 338 transaction,/52/ will often exceed the present value of the future tax savings to the acquiring corporation which will arise from the stepped-up basis./53/

The acquiring corporation, the acquired corporation, and the shareholders and security holders of the target corporation often go to great lengths to structure an acquisitive transaction to fit one or more of the statutory definitions of a tax-free reorganization in order to obtain deferred recognition of gains realized upon the consummation of an acquisitive transaction as well as other favorable federal income tax results. In most situations, a tax-free acquisitive reorganization will not be attempted without the receipt of a favorable private letter ruling from the Internal Revenue Service on the "tax-free" status of the proposed transaction./54/

There can be no question that knowledge of the tax law and intelligent tax planning can often limit or eliminate the immediate recognition of any realized gain or loss to the corporate and noncorporate parties involved in a tax-free reorganization and can result in other favorable federal income tax benefits to the participants. The extensive tax literature on the subject of tax-free reorganizations attests to the importance of the statutory provision from a tax compliance and tax planning perspective./55/ Under current law, the acquisition must constitute a tax-free reorganization at the corporate level in order for either the shareholders or the security holders of the target corporation to enjoy deferred recognition of any gain realized at their levels./56/ Thus the corporate and shareholder/security holder level tax consequences of a tax-free reorganization are coupled or linked. In addition, the tax consequences to one shareholder or security holder may affect the tax consequences to other shareholders and security holders./57/

Subchapter C Revision Act of 1985

The report and suggested statutory language contained in the Subchapter C Revision Act of 1985 were based on detailed studies of Subchapter C performed by the American Law Institute,/58/ a preliminary report issued by the staff of the Senate Finance Committee,/59/ and hearings on the preliminary report./60/ Congress also held hearings on the final report (the Subchapter C Revision Act of 1985)./61/

The Subchapter C Revision Act of 1985 addresses many other issues in addition to the four specific proposals which were of direct concern to this Study. If enacted in its present form, the Act would represent a major change in the federal income taxation of corporations and transactions between corporations and their owners. The four specific changes discussed below illustrate the fundamental nature of many of the changes proposed for the federal income taxation of tax-free reorganizations.

The promulgation of the Subchapter C Revision Act of 1985 illustrates the comprehensive tax reform process in the United States. Several commentators have noted the detailed study of Subchapter C, the issuance of preliminary and final reports, the hearings which were held on both reports, and the recommended statutory language included in the Act are, in many ways, a model of the comprehensive tax reform effort.

Leduc, for example, has stated:

> At many levels, the Staff Report [preliminary report issued by the staff of the Senate Finance Committee] is an unusual document. Procedurally, it is both unusually open in its presentation of the arguments in favor and against the proposals and unusually express in its statement of a staff recommendation on obviously controversial issues. It is also unusual because it is, to such a great extent, the product of a common effort of the Federal Tax policy bureaucracy and of the private tax bar. Finally, the report is unusually derivative, based as it is on the [1982] ALI [American Law Institute] Report./62/

<u>Overall Objective of Act</u>

The overall objective of the Subchapter C Revision Act of 1985 (the Act) is to consolidate, simplify, and make uniform the rules governing corporate mergers and acquisitions, whether treated under the 1954 Code as a reorganization, a liquidating sale under Section 337, or a stock acquisition under Section 338./63/ The Act attempts to provide the same corporate and shareholder level tax consequences for economically equivalent transactions by completely eliminating the current law's statutory and judicial conceptions of a "tax-free acquisitive reorganization."

Specific Proposals

Proposal One: Replace the current definitions of transactions constituting tax-free acquisitive reorganizations with the definitions of transactions constituting qualified acquisitions. The Act would completely eliminate the statutory concept of a "tax-free acquisitive reorganization" and replace it with the broader and more functional concept of a qualified acquisition./64/ New Section 364 would define a "qualified acquisition" as either a "qualified stock acquisition" or as a "qualified asset acquisition." A qualified stock acquisition is defined as any transaction or series of transactions during the 12-month acquisition period in which one corporation acquired stock representing control of another corporation./65/ A qualified asset acquisition is defined as:

1. any statutory merger or consolidation; or
2. any other transaction in which one corporation acquires at least seventy percent of the gross fair market value and at least ninety percent

> of the net fair market value of the assets of another corporation held immediately before the acquisition, and the transferor corporation distributes, within twelve months of the acquisition date, all of its assets (other than assets retained to meet claims) to its shareholders or creditors./66/

Proposal Two: Eliminate three long-standing judicial doctrines as prerequisites for tax-free treatment. In a major change from the present statutory and tax planning environment, the Act provides that the common law judicial doctrines of continuity of interest,/67/ continuity of business enterprise,/68/ and business purpose/69/ would have no applicability in determining whether a transaction constitutes a qualified acquisition./70/ The various studies by the organized tax bar and other responsible commentators have concluded that, on balance, these famous and long-standing judicial doctrines which have been developed over the years allegedly to distinguish taxable sales from tax-free reorganizations and to prevent abuse of the operative provisions for tax-free reorganizations are no longer necessary. One of the principal criticisms of the current law is that the often unknown and possibly unknowable overlaps between the current statutory provisions and these three judicial doctrines do much to cause an unacceptably low level of certainty in planning tax-free acquisitive reorganizations./71/

Proposal Three: Replace the present system of transactional electivity with explicit electivity of corporate level tax consequences. In another major change from the present law, the Act would create new Section 365 which would make the corporate level tax consequences of a qualified acquisition explicitly elective. Stated differently, the Act would change the taxation of acquisitive transactions at the corporate level from a system of transactional electivity--in which the corporations manipulate the type of consideration received, the formation of subsidiaries, and other elements of the transaction in order to achieve desired tax results--to a system of explicit electivity, in which the corporations involved could simply check off a box on a tax form and thereby elect the particular corporate level tax treatment they desire.

Under new Section 365, all qualified acquisitions will be treated as "carryover basis acquisitions" unless an election is made by the corporations involved for the transaction to be treated as a "cost basis acquisition." Unless a timely election is made, the corporate level federal income tax consequences for carryover basis acquisitions will be much the same as for tax-free acquisitive reorganizations under present law. The target corporation will recognize no gain or loss and the acquiring corporation will obtain a carryover basis in any assets acquired/72/ and the tax attributes of the acquired corporation will carryover to the acquiring corporation under

Section 381. A basic premise of the Act is that the carryover basis rules will ensure that the gains realized but not recognized by the acquired corporation will eventually be taken into account.

The Act emphasizes that the corporate level tax consequences result directly from whether the corporations involved explicitly elect to treat a qualified acquisition as either a carryover basis acquisition or as a cost basis acquisition instead of the legal form of the transaction or the type of consideration used. In the case of a cost basis acquisition, the acquired corporation must recognize a gain or loss upon receipt of consideration from the acquiring corporation and the acquiring corporation will obtain a "cost" basis in any assets acquired as determined under Section 1012./73/ In cost basis acquisitions, the tax attributes of the target corporation(s) do not carryover to the acquiring corporation. A basic premise of the Act is that recognition of all gains realized by the acquired corporation is the price that must be paid in order for the acquiring corporation to obtain a step-up in basis of the assets acquired from the target corporation.

Proposal Four: Partially uncouple the corporate and shareholder level tax consequences of a qualified acquisition. In another major change from present law, the Act provides that tax consequences of a qualified acquisition to any shareholder or security holder of the target corporation are to be determined independently of the corporate level tax consequences and independently of the tax consequences to any other shareholder or security holder. Under the Act, even if a qualified acquisition is treated as a cost basis acquisition, it may be wholly or partly tax-free, i.e., tax-deferred, at the shareholder level./74/ As a general rule, the shareholder level tax consequences will be determined on a shareholder-by-shareholder basis so that the tax consequences to one shareholder do not affect the tax consequences to other shareholders of the target corporation./75/

The Act contains the general rule that if the shareholders or security holders of the acquired corporation receive only "qualifying consideration" in a qualified acquisition, gain or loss realized in the transaction will not be immediately recognized. The Act defines "qualifying consideration" as stock or securities of the acquiring corporation./76/ Under the Act, receipt of any other type of consideration, i.e., "nonqualifying consideration," by the shareholders or security holders of the target corporation will generally cause them to immediately recognize any gain or loss realized on the transaction./77/ The Act provides that any gain so recognized will be treated as gain from the sale or exchange of property, i.e., capital gain, unless the receipt of the nonqualifying consideration has the effect of a distribution of a dividend./78/

The Act follows present law in allowing the shareholders and security holders of the acquired corporation to defer recognition of any gains or losses realized if the acquisitive transaction is a "qualified reorganization" but only if "qualifying consideration" is received./79/ Although the Act does much to separate the corporate and shareholder/security level federal income tax consequences as compared with present law, the consequences are still linked because if the overall transaction does not constitute a "qualified acquisition," the shareholders and security holders of the acquired corporation will not be governed by the revised operative provisions and cannot take advantage of the opportunity to defer recognition of gains realized.

Comprehensive Tax Reform Proposals

For the purposes of this Study, the goals of comprehensive tax reform efforts in the United States for the federal income taxation of corporations and their shareholders are categorized as:

1. Major goals--objectives of comprehensive tax reform for the federal income taxation of corporations and their shareholders; and

2. Subgoals--objectives of comprehensive tax reform for the federal income taxation of acquisitive tax-free reorganizations.

Virtually all of the literature on comprehensive tax reform efforts in the United States agrees that equity, economic efficiency, simplicity, and the encouragement of specific activities should be used to evaluate any new tax law or proposed changes in the existing law./80/ These four objectives are used as the major goals or general criteria by which each of the four proposals for change in the Subchapter C Revision Act of 1985 is evaluated.

Because the tax literature does not contain an exhaustive and generally accepted list of specific objectives of comprehensive tax reform efforts in the tax-free acquisition area of the law, such subgoals are developed by the researcher. Each of these subgoals is classified under one of the major goals and is used as the specific criterion by which each of the four proposals for change in the Subchapter C Revision Act of 1985 is evaluated./81/

One of the overall objectives of this Study is to determine whether four specific proposals contained in the Subchapter C Revision Act of 1985 for the federal income taxation of transactions now characterized as tax-free acquisitive reorganizations are consistent with the major goals and subgoals of current comprehensive tax reforms efforts in the United States.

The Research Objective and Specific Research Questions to be Addressed

The objective of this Study is to determine whether the four specific proposals contained in the Subchapter C Revision Act of 1985 for the federal income taxation of tax-free acquisitive reorganizations:

1. are consistent with the stated goals of comprehensive tax reform for the federal income taxation of corporations and their shareholders (major goals);

2. are consistent with the stated goals of comprehensive tax reform for the federal income taxation of tax-free acquisitive reorganizations (subgoals); and

3. represent an appropriate technical response to the major problems associated with the current federal income taxation of tax-free acquisitive reorganizations as identified in the professional and academic tax literature, in hearings held by the Committee on Ways and Means of the United States House of Representatives, the Senate Finance Committee, and other Congressional Committees responsible for federal income tax legislation.

Research questions designed to address these objectives are:

1. What are the major goals of comprehensive tax reform for the federal income taxation of corporations and their shareholders?

2. What are the subgoals of comprehensive tax reform for the federal income taxation of transactions characterized as tax-free acquisitive reorganizations under the 1986 Code?

3. What are the explicit and implicit tax policies underlying the present body of federal income tax law applicable to tax-free acquisitive reorganizations under the 1986 Code?

4. What are the major technical problems associated with the current federal income taxation of tax-free acquisitive reorganizations?

5. What are the explicit and implicit tax policies underlying the four specific changes contained in the Subchapter C Revision Act of 1985 for tax-free acquisitive reorganizations?

6. If the Subchapter C Revision Act of 1985 reflects changes in explicit or implicit tax policies, are the changes in tax policy consistent with the goals of comprehensive tax reform for the federal income taxation of corporations and their shareholders (major goals)?

7. If the Subchapter C Revision Act of 1985 reflects changes in the explicit or implicit tax policies, are the changes in tax policy consistent with the goals of comprehensive tax reform for the federal income taxation of tax-free acquisitive reorganizations (subgoals)?

8. Do the four specific proposals contained in the Subchapter C Revision Act of 1985 represent an appropriate technical response to the major problems associated with the current federal income taxation of tax-free acquisitive reorganizations?

Outline of Chapters

This Study is divided into five chapters with Chapter I serving as the introduction. Chapter II discusses the scope and nature of the Study, the research methodologies utilized, external and internal validity considerations, and the contributions and limitations of the Study. Chapter III discusses the historical development of the definitional and operative statutory provisions and judicial doctrines which currently govern tax-free acquisitive reorganizations. Chapter III also discusses the principal technical, administrative, and tax policy problems associated with the current federal income tax law applicable to tax-free acquisitive reorganizations. Chapter IV describes and discusses in some detail the four changes proposed for the taxation of acquisitive transactions in the Subchapter C Revision Act of 1985, the major and subgoals of comprehensive tax reform efforts in the United States, and evaluates each of the four proposals by these criteria. Chapter V of the Study summarizes the conclusions and provides some recommendations for future research in this area of the tax law.

Chapter II: Research Methodology and Nature of the Study

Introduction

This Study utilizes the research methodologies often employed in public policy research/1/ and policy-oriented tax research/2/ to accomplish the research objectives and address the research questions listed and discussed in Chapter I. The explicit and implicit tax policies underlying the federal income taxation of acquisitive transactions, particularly transactions characterized as tax-free acquisitive reorganizations/3/ under current law, are treated as a public policy susceptible to analysis by these research methodologies. The nature and objectives of this Study make the use of these research methodologies particularly appropriate.

Public Policy Research

A public policy has been defined as: "Whatever governments chose to do or not to do."/4/ Public policy analysis has been defined as: "Finding out what governments do, why they do it, and what difference it makes."/5/ Analysis of public policies involves the following three steps:

1. the systematic identification of the causes and consequences of public policy;

2. where possible, the use of scientific standards of inference; and

3. the search for reliability and generality of knowledge./6/

The public policy literature suggests that in spite of the methodological problems associated with public policy research, which are often the result of the complexity of the subject matter, the broad scope of the research objectives and questions, and the frequent inability to utilize standard research designs to gain efficiency and rule out threats to the internal and external validity of the study and to perform statistical analysis on the data sources,/7/ there is a demand for such research in order that public policy decisions will be made in a more rational and logical fashion than would otherwise be the case./8/

There are two general methods by which public policies can be analyzed: policy determination research and policy impact research. Because of the tax policy orientation of this Study, both of these complementary modes of research are employed. In policy determination research, one studies the causes of existing public policies, such as why the current federal income tax laws applicable to tax-free acquisitive reorganizations were enacted and have or have not been changed over the years./9/ In policy impact research, one studies the actual or likely consequences of public policies, such as the economic, financial, and behavioral consequences of the federal income tax law now applicable to tax-free acquisitive reorganizations and proposed changes in that law./10/

A wide variety of analytical techniques can be appropriately used in performing public policy research./11/ Anderson, for example, states:

> Many valuable and perceptive studies of policy formation exist that employ little or no statistical analysis. The quality of analysis and the use of solid evidence is more important than whether and to what extent quantitative analysis is employed when it comes to determining the value of a study./12/
>
> The field of policy study is open and challenging. It should be especially attractive to those who wish to be "relevant," to engage in research and discovery that has some immediate social utility. Policy study provides ample room for those who are more traditional or more behavioral, more quantitative or nonquantitative, more analytical or more inclined to advocacy, to exercise their talents and pursue their interests. All can contribute through careful scholarship to our knowledge and understanding of public policy and the policy process. Eclecticism in approach helps ensure that fruitful avenues of inquiry will not be closed off by narrow or particular theoretical concerns./13/

Majchrzak notes that although the traditional scientific hypotheses-testing approach fosters thoroughness in scientific exploration:

> the potential loss and misrepresentation of information engendered by taking a singular perspective on a multidimensional problem is too great a risk and a luxury for policy researchers. Therefore, a policy researcher does not approach a social problem with a predetermined theory of its causes and effects./14/

Inductive and Deductive Research

The policy determination and policy impact approaches to study public policies are similar to inductive and deductive research used in financial accounting and taxation. Most commentators on research methodology agree that both inductive and deductive approaches are used to some extent in virtually all research studies./15/ A monograph prepared for the National Association of Accountants contains the following description of the inductive and deductive approaches which is particularly appropriate for this Study:

> Induction is the process by which a theory is generated. Deduction is the process by which a theory is tested. If the researcher does not have an answer to a question and hence embarks on a fact-finding mission, he is engaged in inductive research. If he has what he believes to be an answer to a research question, but wishes to confirm or apply it through further testing, he is engaged in deductive research. It should be clear that "fact finding" verses "testing" is an important dichotomy as it affects the definition of problems, the researchers' attitudes, the selection of methodology, and the very nature of the research activity./16/

An inductive approach is used when the researcher is involved with <u>fact finding</u> and wishes to answer the following types of questions:

1. Which questions: Which direction should we take? Which plan should we follow?
2. Why questions: Why does a certain condition exist? Why did we select this alternative rather than another?
3. What questions: What are the essential variables and parameters of the problem situation?/17/

A deductive approach is used when the researcher is <u>testing a theory</u> and wishes to answer the following types of questions:

1. Will questions: Will it work? Will people accept it?
2. Is questions: Is it the appropriate course of action? Is it the best plan? Is it a good idea?
3. If questions: Will the following consequences occur if we adopt a certain course of action?/18/

This Study utilizes both links of the data-theory-data inference cycle, i.e., the inductive data-theory (theory-building) link and the deductive theory-data (theory-testing) link, to identify and investigate the tax policy considerations and technical problems associated with the current federal income tax law for tax-free acquisitive reorganizations and to investigate and identify the major goals and related subgoals of comprehensive tax reform efforts in this area of the law. This Study utilizes these goals as the general and specific criteria in evaluating four specific changes proposed for acquisitive transactions in the Subchapter C Revision Act of 1985/19/ from a tax policy and a technical perspective.

Because this Study uses the data sources to determine why the current federal income tax law for tax-free acquisitive reorganizations was enacted and has remained essentially unchanged since the Revenue Act of 1934/20/ and to identify the tax policy, technical, and administrative problems associated with the current tax law applicable to acquisitive tax-free reorganizations, a policy determination or theory building approach is used./21/ The use of the inductive approach is most evident in Chapter III of this Study.

Because this Study also uses the data sources and the researcher's judgment to determine whether four proposed changes in the tax law for acquisitive transactions are consistent with the comprehensive reform effort in the United States, a policy impact or theory-testing approach is used./22/ The use of the deductive approach is most evident in Chapter IV of this Study.

As a general rule, the measurements and evaluations involving reported decisions, Congressional Reports, and the tax literature can only be reliably made on a nominal, i.e., yes or no, or present or absent, scale./23/ The nature of this Study allows the researcher to make a nominal level judgment as to whether the enactment of each of the four proposals would represent an improvement in the current federal income tax law for acquisitive transactions based on the major goals and related subgoals used as the criteria./24/

The data sources consulted in this Study are used primarily to identify the major goals and related subgoals of comprehensive tax reform efforts in this area of the law,/25/ rather than to test null and alternative hypotheses deducted from some well-accepted theory./26/ The broad scope of this Study, the approximately equal use of both links of the inference cycle, and the impossibility of making reliable and replicable quantitative observations or measurements on the data sources dictate the use of research methodologies utilized in public policy research and render the use of standard research designs/27/ and statistical tests/28/ commonly utilized in empirical research inappropriate.

Policy-Oriented and Theoretical Tax Research

This Study follows the general approach to policy-oriented tax research employed by both academic and practicing accountants and attorneys. In a paper presented at the 1984 Accounting Research Convocation, John Kramer of the University of Florida made a number of observations which are timely and relevant to this Study./29/ In terms of Kramer's typology of tax research methodologies, this Study fits within the categories of historical or archival research, theoretical research, and tax policy research.

Kramer cautions researchers not to expect too much from theoretical tax research. This Study is theoretical in that it investigates some of the federal income tax policy implications of four specific changes proposed in the Subchapter C Revision Act of 1985 in a specific area of the federal income tax law. Kramer states:

> The term theoretical research is defined as "relating to or having the character of a theory." Thus, one might characterize theoretical research as being a system of assumptions, principles, and rules of procedures devised to analyze, predict, or otherwise explain the nature or behavior of a specified set of facts. This set of assumptions, principles, and rules is many times created in an attempt to develop a framework or theory from which to carry out empirical research on a question.
>
> Academic accountants have done very little theoretical tax research. Most of the theoretical tax research has been done by economists. Two problems are characteristic of much of the theoretical tax research that has been performed. First, the analysis is conducted under a set of necessarily restrictive assumptions. Many times the model constructed is so simple that it cannot be tested. Relaxing the assumptions of the initial model may involve a greater number of equations and variables. The results obtained from the revised model may serve to confirm or contradict the results of the initial model and may permit subsequent empirical testing.
>
> Second, many theoretical research efforts analyze a current problem or decision and downplay any tax policy implications that the research results may have. If used creatively, theoretical research efforts could serve as an alternative to analyze the policy implications of greater numbers of current decisions and problems./30/

Hopefully, this Study is conducted in a manner which takes advantage of the benefits of theoretical tax research while avoiding the limitations noted above.

In commenting on tax policy research, Kramer also states:

> Tax policy research includes research efforts conducted to answer policy questions as well as research that aids others in conducting policy research. Quite often this type of research examines a legislative proposal or a specific piece of legislation that has been enacted to see whether the proposal or legislation satisfies certain economic and/or social

> objectives. This research can take on a number of forms. For example, some tax policy studies are conducted before a specific piece of legislation is enacted in an attempt to estimate the economic or social consequences of the proposed changes . . . Most tax policy research is conducted after the tax law changes occur. Some of the ex-post studies are directed at determining the effectiveness of a particular legislative change./31/

Kramer observes that policy-oriented tax research often is an inductive or deductive type of research that involves a conceptual analysis of legal and economic principles and that the typical policy-oriented research does not involve economic modeling or descriptive statistical analysis./32/

Similarity to Other Studies

A review of policy-oriented tax research conducted by academic accountants and attorneys/33/ indicates that the following seven step approach has frequently been utilized in an effective manner:

1. Select a fairly broad topic of continuing importance from a tax policy perspective.

2. Review the major judicial decisions in this area of the law giving due consideration to the facts involved in each decision./34/

3. Consider the specific statutes involved and the dynamic nature of the law as interpreted by the courts./35/

4. Consider the administrative practice and regulations issued by the Treasury Department to interpret the Internal Revenue Code. In certain areas of the law, including tax-free acquisitive reorganizations, Congress has often contented itself, particularly in the early acts, with the statement of a general rule with the details of its application to be worked through Treasury regula-

tions and rulings and a great many judicial decisions./36/

5. Recognize the interaction between the statutory provisions as written and subsequent changes dictated by experience and practical enforcement problems. In the area of tax-free acquisitive reorganizations, the Treasury Department's recommendations for modifications of the basic provisions in the law have frequently been adopted by Congress, particularly when supported by arguments from its experience in administering past laws./37/

6. Examine the principal economic consequences of the law as it has developed over time by reference to a variety of sources including reported decisions, the tax literature, and previous attempts at tax reform in this area of the law.

7. Where possible, (A) construct numerical examples or case studies of how the specific tax statutes are designed to work based on the explicit and implicit tax policy considerations existing at the time the statutes were enacted or amended, (B) determine how the statutory provisions actually operate in practice, and (C) use a logical and conceptual type of analysis to draw conclusions about the appropriateness of the statutory provisions from a tax policy and technical perspective./38/

This seven step approach outlined above is consistent with the policy determination and policy impact approaches used to conduct this Study.

Concern With Tax Policy Issues

Much of the policy-oriented tax research conducted by academic accountants and attorneys has long taken the position that concern about the explicit and implicit tax policies underlying major areas of the federal income tax law is always warranted./39/ Magill, for example, notes that for any person or group to rationally consider the various impacts of the federal income tax law, there is an ever present need for a set of guides or canons by which to judge or evaluate the present law and to recommend changes to improve the present tax structure./40/ Magill observed in 1943 that the federal income tax law rests on some fundamental canons and that:

> On the whole, we have probably spent too much time on minor loopholes and minor changes. That is one good reason why our tax law becomes technically more complicated and unintelligible each year./41/

Many commentators, including Magill, note a practical or pragmatic aspect to studies of tax policy issues:

> Scholars can delay judgment about effects of various changes in tax but a legislator and a businessman cannot. Taxes must be collected and paid every day. A decision by Congress even to maintain the status quo will have great repercussions./42/

Internal and External Validity

Academic research is often evaluated, at least in part, by its internal and external validity. In most narrowly focused empirical studies, there is a clear and inevitable trade-off between these two types of validity: one can achieve higher internal validity only at a cost of lower external validity and vice versa./43/ Stated differently, one can be more certain of the internal validity of the study, i.e., that the presumed relationship between the independent and dependent variable(s) is due to the hypothesized factors rather than other intervening or confounding factors, only by reducing the external validity, i.e., the generalizability, of the study./44/

The external validity of a study is a function of the data sources utilized. The results of a study, even one having high internal validity, cannot be properly generalized beyond the type of data sources on which the inferences and conclusions are based.

This Study is most concerned with its internal validity. In other words, the most important methodological concern is that a valid determination be made about the appropriateness of the four proposed changes contained in the Subchapter C Revision Act of 1985 for acquisitive transactions from a tax policy and technical perspective given the major goals and related subgoals used as the general and specific criteria. Because this Study is expressly limited to an investigation of the federal income taxation of five types of transactions characterized as tax-free acquisitive reorganizations under current law, there is less concern about the external validity than the internal validity. The use of the policy determination and policy impact approaches discussed above should cause this Study to have a sufficiently high level of internal validity and allow it to make a contribution to the tax literature.

Data Sources

Many data sources could have an important bearing on the research objective and research questions addressed in this Study. Therefore, reported court decisions, Congressional Reports on tax legislation, the tax literature, etc., were examined as deemed necessary by the researcher. Given the importance of gaining a sound historical perspective on how and why the current body of federal income tax law applicable to tax-free acquisitive reorganizations has developed over the years, a wide variety of data sources was consulted.

By examining all documents deemed necessary to trace the development of the current statutory and judicial doctrines applicable to five types of acquisitive tax-free reorganizations defined in the current law, to determine the tax policy and technical problems associated with the current tax law for tax-free acquisitive reorganizations, and to understand the rationale for the specific changes proposed by individual commentators and, ultimately, Congress in the Subchapter C Revision Act of 1985, the logic and reasoning process utilized by Congress in proposing the four specific changes which are the principal focus of this study was investigated in detail.

The data sources utilized in conducting this Study include the following items:

1. Reported decisions of all levels of federal courts which hear federal income tax cases;

2. Administrative pronouncements of the Internal Revenue Service;

3. Committee Reports of those Congressional bodies responsible for federal income tax legislation/45/;

4. Academic and professional tax literature, including previous doctoral dissertations/46/;

5. Loose-leaf tax services, treatises, and other specialized relevant tax services/47/;

6. Congressional and other material applicable to comprehensive tax reform efforts generally and reform efforts for the federal income taxation of corporations and their shareholders/48/; and

7. Other documents deemed relevant by the researcher, including hearings before tax-writing and other Congressional Committees responsible for federal income tax legislation./49/

Scope and Limitations of the Study

Due to the stated research objective and related research questions, the scope of this Study is broad. The most important reason for the extensive scope of the Study is the importance of gaining a sound understanding of the historical development of the statutory provisions, regulations, applicable common law judicial doctrines, administrative practices of the Internal Revenue Service, and the general institutional factors which together constitute the present body of federal income tax law for tax-free acquisitive reorganizations. Although a historical perspective is useful for virtually any type of tax research, such a perspective is deemed particularly important for this Study given the fundamental nature of the changes proposed for the federal income taxation of acquisitive transactions in the Subchapter C Revision Act of 1985./50/

The scope of this Study is necessary in order to gain an understanding of the various factors which have caused Congress to finally propose some specific legislation in this area of the federal income tax law and to make the four specific proposals which were investigated in this Study. As discussed in Chapter I, the existence of problems in the current federal income tax scheme applicable to tax-free acquisitive reorganizations has been acknowledged for some time. What is unique is that the work of the organized tax bar, the American Institute of Certified Public Accountants, individual commentators, Congressional Committees, and other concerned groups has finally been used by Congress to propose and support detailed legislation for the specific purpose of addressing at least some of the major problems associated with the current tax law for acquisitive transactions, particularly tax-free acquisitive reorganizations. As is the case for all policy-oriented tax research, both the conduct and conclusions of this Study are subject to a number of limitations. The six principal limitations of this Study are discussed below.

1. The data sources used in this Study are limited to that material which is available to a tax professional. Neither the tax returns of individual corporations nor internal tax compliance and tax planning memorandum are publicly available. Over the years, there have undoubtedly been disputes between taxpayers and the Internal Revenue Service which were settled administratively and which may have been relevant in satisfying the research objective. As the existence and details of these tax returns, internal memoranda, and disagreements between corporations and the Internal Revenue Service are not publicly available, they are not used in conducting this Study. The data sources used in conducting this Study are limited to the type of publicly available federal income tax information normally found in a law school library and in a United States Government Documents Depository.

2. The analysis of reported decisions and the other data sources used in this Study is subject to a number of limitations. One inherent limitation of any study of the federal income tax law is that because many important questions have never been presented to the United States Supreme Court, some questions and issues remain unsettled./51/ Only a very small percentage of federal income tax cases ever reach the United States Supreme Court. The tax law thus develops primarily by the administrative ac-

tions of the Internal Revenue Service and decisions of the lower courts./52/

3. Any research which attempts to analyze the historical development of long-standing statutory provisions and judicial doctrines faces the problem that the judicial opinions and decisions as well as the related tax literatures express the thoughts and conclusions of commentators and judges as developed over a long period of time. The researcher must be sensitive to the changes in economic and financial conditions which have occurred over the years./53/

4. A fourth limitation of this Study is the result of its broad scope. As Magill noted in 1945 in his treatise, Taxable Income:

> The task of outlining a history and analysis of decisions and statutes in which so many judges and legislators have participated is not easy. The danger of oversimplification is very real, since one of my chief purposes has been to make this great mass of material intelligible. A secondary and equally difficult task was to select significant lower court decisions on which the Supreme Court has not passed. It is almost too much to hope that both objectives have been acceptably accomplished./54/

5. There is the possibility of researcher bias in selecting, reading, analyzing, and interpreting the various reported decisions, Congressional Reports, Internal Revenue Service pronouncements, the tax literature, etc. Any potential researcher bias is mitigated by the following factors:

a. The Study contains a detailed description of the historical development of the current body of law applicable to tax-free acquisitive reorganizations.

b. The Study contains a detailed discussion of the major goals and subgoals of comprehensive tax reform efforts in this area of the federal income tax law.

c. The Study contains a detailed analysis and evaluation of the four specific proposals contained in the Subchapter C Revision Act of 1985 which were the subject of this research.

d. As a result of the discussion of the proposed changes and the major goals and related subgoals of comprehensive tax reform efforts which served as the general and specific criteria used to evaluate these proposed changes, any researcher bias should be evident to the reader./55/

6. A sixth limitation of this Study is its limited external validity or generalizability. Although the other types of tax-free reorganizations recognized under current law, i.e., divisive reorganizations and reorganizations of single corporations, and many important aspects of the federal income tax law applicable to corporations and their shareholders generally, would be materially altered if the Subchapter C Revision Act of 1985 is enacted in its present form, these changes are not considered in conducting this Study unless they have an important and direct bearing on the research objective and questions.

Although the state and local income tax consequences of acquisitive transactions are important consideration in structuring transactions, they are not addressed in this Study./56/ In addition, it must be recognized that policy research is to some extent a value-laden process and that failure to recognize it as such often limits the generalizability of the study./57/

Contribution of the Study

The four changes proposed for the federal income taxation of acquisitive transactions in the Subchapter C Revision Act of 1985 carry a number of important tax policy consequences which are identified and explored in this Study. These proposed changes are a current example of how Congress eventually reacts to criticism of current federal income tax statutes by individual commentators, the organized tax bar, the American Institute of Certified Public Accountants, and various agencies of the United States government. The promulgation of the four proposed changes investigated in this Study, combined with the ultimate enactment or nonenactment of these changes into the Internal Revenue Code, illustrates the comprehensive tax reform process in action. By evaluating the tax policy and related technical issues underlying these proposed changes this Study will make a contribution to the tax literature.

Chapter III: Tax Policy and Technical Problems Associated with the Tax Law for Tax-Free Acquisitive Reorganizations

Introduction

The purpose of this Chapter is to discuss the principal tax policies, technical issues, questions, and problems associated with the federal income tax law for transactions structured as tax-free acquisitive reorganizations under the 1986 Code. Due to the interrelated nature of Subchapter C transactions and the existence of categorical distinctions between various types of economically similar acquisitive transactions, tax policies, technical issues, questions, and problems associated with the current tax law for nonreorganization acquisitive transactions, particularly purchases of corporate stock, complete liquidations, and acquisitions of corporate stock treated as the acquisition of the underlying corporate assets under Section 338, will also be discussed./1/

Many of the problems discussed in this Chapter have existed for some time./2/ After several years of study, issuing Preliminary Staff Proposals, and holding hearings on the Preliminary Staff Proposals, the Senate Finance Committee made its final recommendations for major changes in Subchapter C in the Subchapter C Revision Act of 1985 (the Act)./3/ Because the overall objective of this Study is to investigate and evaluate four proposed changes contained in the Act for acquisitive transactions broadly defined (the acquisition proposals), this Chapter introduces the principal federal income tax issues and problems relating to acquisitive transactions, provides an overview of the acquisition proposals, and then discusses in some detail the specific tax policy and technical problems each proposal is intended to remedy.

Appendix A contains a brief summary of the historical evolution of the statutory definitions, operative provisions, and judicial doctrines/4/ applicable to transactions structured as tax-free acquisitive reorganizations under the 1986 Code./5/ Appendix A also contains a brief discussion of the changes made in the Internal Revenue Code by the Tax Reform Act of 1986 (TRA of 1986)/6/ and the principal unresolved tax policy issues for acquisitive transactions, some of which are addressed by the acquisition proposals./7/

The issues and problems discussed in this Chapter were identified as a result of a detailed review and study of the financial,/8/ empirical,/9/ managerial,/10/ tax,/11/ and other relevant literature, Congressional committee reports,/12/ and hearings before Congressional committees./13/ Gaining a sound understanding of the historical development of the statutory provisions/14/ and judicial doctrines/15/ is vital to making a valid evaluation of the acquisition proposals./16/

Chronology of Acquisition Proposals

Before discussing the various tax policy and technical issues and problems addressed by the Act, it may be helpful to briefly review the historical development of the acquisition proposals. To a large extent, the proposals are based on the recommendations of various studies of Subchapter C performed by the American Law Institute (ALI), the recommendations of the staff of the Senate Finance Committee,/17/ and the views of individual commentators.

The development of the acquisition proposals and their tax policy rationale is contained primarily in the following documents:

1. Federal Income Tax Project Subchapter C Tentative Draft No. 1 (1977 ALI Study);/18/

2. Federal Income Tax Project (1980 ALI Study);/19/

3. Federal Income Tax Project Subchapter C--Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions (1982 ALI Study);/20/

4. Preliminary Report issued by the Staff of the Senate Finance Committee in September 1983 entitled The Reform and Simplification of the Income Taxation of Corporations (Preliminary Staff Proposals);/21/

5. Hearings held by the Senate Finance Committee in 1983 on the Preliminary Staff Proposals (1983 Hearings on Reform of Corporate Taxation);

6. Final Report entitled The Subchapter C Revision Act of 1985 issued by the Staff of the Committee on Finance in May 1985; and

7. Hearings held by the Senate Finance Committee in 1985 on The Subchapter C Revision Act of 1985 (1985 Hearings on Reform of Corporate Taxation).

Criticisms of Existing Law

The current tax law for acquisitive transactions has long been criticized on a number of tax policy, technical, and economic grounds./22/ General criticisms are based on objections to the imposition of an unintegrated two-tier corporate income tax and the resultant attempts by corporations and their shareholders to minimize their tax liabilities./23/ Because the present corporate and shareholder income tax and federal estate and gift tax systems provide significant economic and tax incentives for structuring acquisitive transactions as some type of carryover basis transaction (e.g., a purchase of corporate stock or a tax-free acquisitive reorganization) rather than as a taxable transaction, the tax law has been criticized for providing unwarranted incentives for certain types of acquisitive transactions and for penalizing others./24/

Several commentators have criticized Congress for enacting, continuing, and expanding the tax-free reorganization provisions since their origin in the Revenue Act of 1918./25/ The complexity of Subchapter C/26/ and of the tax laws directly applicable to acquisitive transactions/27/ has had a number of adverse effects on the practice and administration of the federal income tax laws. The complexity of the various statutory, judicial, and administrative provisions for economically similar transactions seems to have created a Gresham's law of tax practice and to have caused a decline in respect for the federal tax law./28/

The complexity of the tax provisions applicable to acquisitive transactions may allow the Internal Revenue Service (the Service) to make tax laws instead of enforcing the laws written by Congress./29/ The present tax law for acquisitive transactions may be horizontally inequitable (i.e., economically similar transactions are not taxed in the same manner) because all taxpayers do not have equal access to sophisticated tax counsel and may be otherwise unable to utilize the complexities and discontinuities in the law to achieve their objectives./30/ The present tax law may be economically inefficient (nonneutral) because similar transactions are often distinguished for tax purposes based on their legal forms or on other matters of corporate procedure rather than by their economic substance./31/

Many commentators criticize Congress for continuing the categorical distinctions between "tax-free reorganizations" and other types of acquisitive transactions in the 1986 Code on technical/32/ and tax policy grounds./33/ Because Congress did not enact the acquisition proposals in conjunction with the repeal of the General Utilities doctrine in the Tax Reform Act of 1986, the tax law has exacerbated the differences in, and discontinuities between, stock and asset acquisitions, has left the tax law for acquisitive transactions in a state of disequilibrium,/34/ and may make it more difficult for Congress to address some of the major tax policy issues for acquisitive transactions in the future.

Congress, the courts, and the Service/35/ have found it very difficult to implement the Supreme Court's decisions (1) that there really is a distinction between taxable sales of businesses and tax-free reorganizations/36/ and (2) that distinction is mainly whether the target shareholders have a continuing equity interest in the acquiring corporation/37/ and whether the acquiring corporation continues the business of the target corporation or continues to use the assets of the target corporation in its business. Many commentators conclude that these problems illustrate the existence of fundamental unresolved tax policy problems for acquisitive transactions./38/ The most important policy issues for acquisitive transactions are whether the tax law should continue to implement traditional notions of a "tax-free reorganization," should use the judicial requirements to distinguish tax-free reorganizations and sales of businesses, should continue the categorical distinctions between reorganization and non-reorganization acquisitive transactions, and should continue the system of transactional electivity found in the 1954 and 1986 Codes./39/

Congress has experienced many difficulties in enacting tax provisions which simply and rationally distinguish sales of corporate businesses, i.e., taxable transactions in which any gain realized is immediately recognized, and "tax-free" acquisitive reorganizations, i.e., transactions in which any gain realized by the target corporation is generally not recognized and any gain realized by the shareholders and security holders of the target corporation is immediately recognized only to the extent of boot received with the basis rules operating to preserve the deferred gain for recognition at a future date. Enactment of tax provisions which do not interfere with economically warranted and socially beneficial business restructurings and which do not make the business planning environment uncertain/40/ has also proven to be extremely difficult.

Congress has previously considered comprehensive tax reform proposals, including proposals to completely eliminate the tax-free reorganization provisions. In enacting the Revenue Act of 1934, Congress did not act on arguments that the administrative and judicial experiences to date with the tax-free reorganization provisions justified their complete repeal./41/ In enacting the 1954 Code, Congress did not act on arguments that the special provisions for tax-free reorganizations should be substantially altered/42/ in order to tax economically similar transactions in the same manner, to not continue the elevation of legal form over economic substance, and to prevent taxpayers from gaining unwarranted tax benefits from the reorganization provisions./43/ In the broad historical context, the acquisition proposals represent one of the most comprehensive tax reform attempts to date for acquisitive transactions broadly defined./44/

Many of the arguments recently advocated in support of the acquisition proposals (e.g., the tax law should be much simpler and more rational, the tax law should be more neutral as to how an acquisitive transaction is effected) have been used unsuccessfully in the past in attempting to persuade Congress to comprehensively reform the taxation of acquisitive transactions. Sandberg's criticism of the tax-free reorganization provisions in 1938 reflects many of the tax policy concerns currently expressed by individual commentators, the ALI, and Congress:

> There are three striking things about the reorganization sections of the federal income tax law. The first is their almost unbelievable intricacy. The second is that due to this very intricacy, they have been in the past, and, despite the President's inquiry of 1937, possibly still are, one of the most serious tax avoidance leaks in the capital gains tax. But the most striking thing of all is that no one can explain why they were enacted or why, having been enacted, they have remained.

With federal tax reform the issue of the hour, these

> problems move into sharper focus. If, in response to demands now being made, Congress repeals the capital gains tax, the reorganizations sections will go also since they are intended to alleviate of that tax. But if, as is more likely, the capital gains tax is retained, there remains the problem of tax simplification, that of tax avoidance, and a host of others of deeper import which lie beneath the surface of the statutes. Whatever the particular issue involved, these complex and cryptic laws are sure to figure preeminently in the coming Congressional deliberations. (emphasis added)/45/

Securing the benefits of tax-free reorganization treatment for acquisitive transactions is often very expensive and may not represent an appropriate use of society's scarce resources. The current statutory provisions and judicial doctrines applicable to acquisitive transactions are so complex and emphasize legal form over economic substance to such a degree that virtually all Subchapter C studies have recommended simplification and rationalization. Categorizing economically similar acquisitive transactions into "taxable" and "carryover" basis categories with different, and often conflicting, sets of tax provisions at both the corporate and noncorporate levels has been singled out for criticism./46/

Although the 1984 comprehensive tax reform proposals of the Treasury Department (Treasury I)/47/ or the Reagan Administration (Treasury II)/48/ did not make specific recommendations about the tax-free reorganizations, Treasury I did state:

> . . . in general, no proposals have been made regarding the taxation of corporate liquidations, re-

> organizations, or the carryover of corporate tax attributes, including net operating losses. The rules in these areas are frequently cited as in need of reform, and important work has been undertaken in a number of sectors to rationalize and simplify current law. The Treasury Department is interested in and supportive of efforts to reform current rules for the taxation of corporations and shareholders. No inference should be drawn from the fact that these issues have not been addressed in the Treasury Department proposals./49/

Bittker and Eustice, the leading commentators on Subchapter C of the Internal Revenue Code, have stated:

> The reorganization provisions are extraordinarily complex, even for the Internal Revenue Code. They endeavor to prescribe, in a few sentences, the tax treatment of a diversity of transactions that have little in common when viewed from the standpoint of business, financial, or economic purposes or results. They have been altered by Congress every few years, always ad hoc, and the earlier versions continue to govern the basis of assets and stock acquired in ancient reorganizations, as well as to influence the administrative and judicial construction of today's statute.
>
> There is a good deal of interplay, overlap, and conflict between the reorganization provisions and such other statutory provisions such as Sec. 301 (distributions of cash and other property), Sec. 302 (redemptions of stock), Sec. 305 (stock dividends), Sec. 306 (preferred stock), Sec. 331 (partial and complete liquidations), and Sec. 355 (corporate divisions), since any of these events may accompany, be part of, or serve as a substitute for a reorganization. There is a similar conflict of jurisdiction within the reorganization provisions themselves, since--to take but one example--a statutory merger may be indistinguishable in results from an exchange by one corporation of its voting stock for all of the assets of another corporation; but different statutory rules are prescribed for these functionally equivalent reorganizations./50/

Each of the ALI and Congressional studies of the provisions governing acquisitive transactions notes that although complexity, the elevation of form over substance, the continuation of the categorical distinctions between "reorganizations" and other types of economically similar acquisitive transactions, the tendency of the income tax system to either reward or penalize taxable acquisitions vis-a-vis carryover basis acquisitions,/51/ and myriad other problems have been recognized for some time, Congress has not acted effectively to deal with them. In fact, the actions taken to date may have added to the complexity and uncertainty of the tax law.

The Preliminary Staff Proposals state:

> The fundamental principles of the Federal corporate tax have not been reexamined by Congress for at least 30 years. Indeed, the reorganization provisions have not been carefully examined since the enactment of the Revenue Act of 1934. There have been a number of limited amendments to the rules, and the net result of those amendments has been, in certain respects, additional complexity. Moreover, many of those changes have been relatively ineffective. For example, in 1969, the Congress sought narrow solutions to certain perceived abuses involving redemptions of stock with appreciated property, debt financed corporate acquisitions, and from taxable corporate distributions. None of these provisions has been particularly effective. Although changes were made to the corporate tax in 1982, most of these changes were in the nature of a stopgap solution to a narrow set of particularly serious abuses.
>
> Since enactment of the 1954 Code there have been recurring recommendations from the organized tax bar to restructure substantially the corporate income tax. When the [Senate Finance] committee heard testimony last year on the proposed changes to the treatment of certain taxable acquisitions, several witnesses suggested a more comprehensive study and revision of corporate taxation.
>
> The committee's recent success with a fundamental re-

> examination of the rules governing small business corporations (S corporations) and the revision of the installment sales rules has demonstrated the benefits of such an approach. Moreover, the increased opportunities for many corporations to avoid entirely the corporate income tax by making a subchapter S election has increased the opportunity to simplify the corporate tax rules. A limited number of fundamental changes to the corporate income tax will simplify and reform current law./52/

In justifying the enactment of the acquisition proposals, the Act states:

> . . . the current law of Subchapter C is seriously flawed. The 'law' consists of a series of rules, some statutory and others of judicial origin, which, when taken together, lack consistency, are unnecessarily complex, and are often subject to manipulation. By providing uncertain and often capricious tax consequences to business transactions, the law inadequately addresses the needs of businessmen, their corporations, and their investors. Moreover, by being inconsistent and subject to manipulation, the law is biased, at times encouraging tax-motivated transactions, and at times discouraging or making less efficient legitimate business dealings. It is far from clear whether the bias of current law serves any particular Congressional policy goal. Further, it is highly questionable, given the complexity and uncertainty of current law, whether any Congressional policy initiatives could effectively be implemented if the present structure of Subchapter C were retained./53/

Congress Has Not Addressed Fundamental Tax Policy Issues

Many of the present problems for acquisitive transactions arise from the complexity of Subchapter C itself,/54/ the tendency of Congress to use the tax laws to accomplish a wide variety of nontax objectives,/55/ and the other provisions of Subchapter C including the deductibility of interest expense, the attractiveness of reporting recognized gains on the installment method,/56/

and, under the 1954 Code, tailoring acquisitive transactions to take advantage of the corporate level nonrecognition of gain in certain taxable acquisitions./57/

Certain commentators argue that until Congress is willing to address the fundamental issue of conforming the tax treatment of stock and asset acquisitions,/58/ which would alter long-held notions of what constitutes realization and recognition of gain and loss in acquisitive transactions/59/ and the relationship of parent and subsidiary corporations in acquisitive transactions,/60/ comprehensive tax reform for acquisitive transactions can only be accomplished on a piecemeal basis with a high probability of unsatisfactory results./61/

The acquisition proposals follow Jacob's observation that the long history and nearly universal acceptance of the principle of tax-free reorganization exchanges by corporations and their shareholders is probably too well accepted and settled to accommodate serious consideration of the desirability of completely eliminating the operative provisions of the current law for either the corporate or noncorporate parties involved./62/ The acquisition proposals continue the direct trade-off of gain recognition (nonrecognition) to the target corporation and the acquiring corporation taking a cost (carryover) basis in the target's assets and make it available by explicit election rather than manipulation of the legal form of the transaction. Although it is trivial to demonstrate that this trade-off is not equivalent on a present value basis,/63/ the "tax cost basis doctrine" is a fundamental aspect of the unindexed federal income tax law in the United States./64/

The acquisition proposals continue and effectively expand the present <u>operative</u> provisions for tax-free reorganizations to a much broader class of acquisitive transactions which are called qualified acquisitions (QAs)./65/ Whether the expansion of tax-free treatment at the corporate, shareholder, and security holder levels will ultimately cause the reinstitution of long-standing judicial safeguards such as the continuity of interest, continuity of business enterprise, and business purpose doctrines to distinguish sales and QAs and to protect the integrity of the statutory nonrecognition provisions cannot be predicted./66/ Based on the problems encountered to date, it seems clear that continued use of these judicially-created prerequisites will do little to resolve the lack of predictability, boundary, and other problems caused by these requirements under the 1954 and 1986 Codes./67/

The Act takes a piecemeal approach to tax reform for acquisitive transactions. The 1982 ALI Study states:

> To a considerable extent, these [acquisition] proposals represent a restatement of existing law along more functional and coherent lines. The greatly simplified categorization of acquisition transactions that is proposed, and its elective character, are im-

> plicit in the existing rules, and the main effect of the proposals is just to bring these characteristics out in the open./68/

Attempting to accomplish tax reform in a piecemeal fashion can result in many problems as demonstrated by the effect of the TRA of 1986 on the provisions of the 1986 Code governing acquisitive transactions. In commenting on the TRA of 1986, Knight and Knight observe that although Congress expressed an interest in neutralizing the impact of the tax system on mergers and acquisitions, this objective was not achieved because this tax reform did not address some major tax policy issues including the deductibility of interest expense on acquisition indebtedness, installment reporting of recognized gain in merger and acquisition transactions, and the imposition of penalties on the recipients of greenmail payments./69/ Knight and Knight state:

> In all fairness to Congress, however, one must acknowledge that to address these issues is to consider a sweeping reform of the corporate tax law. For example, eliminating the deductibility of interest, in and of itself, is not likely to stem the level of takeover, merger, and acquisition activity. Furthermore, such an action may produce undesirable side effects since interest deductibility affects more than the parties to the transaction.
>
> The other takeover, merger, and acquisition concerns also cut into basic, pervasive taxing concerns. Dealing with one or more of these in a piecemeal fashion, such as Congress did in the 1986 Act, is not likely to accomplish the goal of neutralizing the tax system. Moreover, this piecemeal approach runs the risk of creating additional tax loopholes for the ingenious tax professional to exploit./70/

Overview of the Acquisition Proposals

To simplify and rationalize the tax law and to provide similar tax consequences for economically similar acquisitive transactions, the Act eliminates the present statutory definitions for various types of tax-free acquisitive reorganizations and Section 338 transactions, eliminates categorical distinctions between the various types of acquisitive transactions found in the 1986 Code, and broadens the number of acquisitive transactions which can obtain tax-free treatment at the target corporation, shareholder, and security holder level as compared to the 1986 Code.

The Act introduces the concept of, and specific statutory definitions for, two types of QAs: qualified asset acquisitions (QAAs) and qualified stock acquisitions (QSAs). QAs are broadly defined to include purchases of a controlling interest in the stock of a target corporation and acquisitive transactions classified as tax-free acquisitive reorganizations and Section 338 transactions under the 1986 Code.

The Act completely eliminates the judicial doctrines of continuity of interest, continuity of business enterprise, and business purpose as prerequisites for QA status. The Act thus repeals all notions of continuity of interest at both the corporate level and the shareholder level./71/ Aside from complying with the statutorily defined form of a QA, the Act contains no judicial doctrines or other extrastatutory requirements which prevent an acquisitive transaction from achieving tax-free treatment at the target corporation level./72/

The Act accepts the widely-held conclusions that the 1986 Code provisions governing acquisitive transactions are effectively elective for well-advised taxpayers/73/ and that the legal form and other matters of corporate procedure play too important a role in determining the tax consequences of acquisitive transactions at the target corporation and target shareholder and security holder levels. The Act attempts to deemphasize the role of the legal form of the transaction and other matters of corporate procedure in determining the corporate level tax consequences of a QA and attempts to eliminate many of the differences in statutory definitions and consistency requirements for tax-free acquisitive reorganizations and Section 338 transactions and discontinuities between stock and asset acquisitions found in the 1954 and 1986 Codes./74/ The Act thus attempts to eliminate several sources of economic inefficiency found in the 1954 and 1986 Codes.

The Act eliminates the system of transactional electivity found in the 1954 and 1986 Codes by allowing the corporate parties to a QA to explicitly elect a cost or carryover basis for the target's assets. If cost basis treatment is elected, the acquiring corporation will take a cost basis in the target's assets and the target corporation will recognize all gain realized. If carryover basis treatment is elected, the acquiring corporation will take a carryover basis in the target's assets but the target corporation will recognize no gain.

The Act takes the position that allowing explicit corporate level electivity for QAs is the most efficient and least disruptive approach/75/ for determining whether the target corporation does or does not recognize gain, whether the acquiring corporation takes a cost or carryover basis in the target's assets, and the disposition of the conditional and potential tax liabilities of the target corporation which exist at the time of an acquisition./76/

By separating the issues of the legal form of the transaction and the type of consideration used by the acquiring corporation from the issues of whether the assets of the target corporation will take a cost or carryover basis in the hands of the acquiring corporation and how the conditional and potential tax liabilities of the target corporation are handled, the Act departs significantly from historical notions of how a tax-free acquisitive transaction differs from a taxable sale of a business. By allowing elective carryover basis treatment even if the acquiring corporation uses all cash consideration in a QA, the Act departs from a fundamental premise of current law that cash sales of a corporation's assets should be a recognition event at the selling (target) corporation level./77/

The Act completely eliminates the concept of a "tax-free acquisitive reorganization" contemplated by the 1954 and 1986 Codes, the regulations, administrative pronouncements issued by the Service, and the case law./78/ The Act repeals the requirement that in order to achieve tax-free treatment, acquisitive transactions must proceed under "a plan of reorganization"/79/ or similar formal plan.

The Act completes the elimination of the historical "tax-free reorganization" concept by partially separating the target corporation and target shareholder and security holder level tax consequences of QAs. If a target shareholder or security holder receives only qualifying consideration in a QA, no gain will be recognized irrespective of any election which is made by the acquiring corporation/80/ and irrespective of the consideration received by the other target shareholders and security holders. With the exception of allowing the tax consequences of each shareholder and security holder of the target corporation to be determined independently of the corporate level consequences and the tax consequences of the other shareholders and security holders, the Act makes no major changes in the current <u>operative</u> provisions applicable to shareholders and security holders in tax-free acquisitive reorganizations as defined in the 1986 Code./81/

<u>Proposal One</u>

> The Act repeals present Section 368 and creates new Section 364. Section 364 contains the statutory definition of a "qualified acquisition" which includes "qualified asset acquisitions" and "qualified stock acquisitions." Qualified acquisitions encompass each of the five types of tax-free acquisitive reorganizations defined in current law which were the subject of this Study and transactions described as Section 338 transactions in the 1986 Code./82/

Proposal One implements one of the overall objectives of the Act: eliminating the categorical distinctions between reorganizations and other types of acquisitive transactions under the 1954 and 1986 Codes in order to make the law simpler, more rational, consistent, and certain. Proposal One repeals the present statutory definitions for the eight forms of tax-free acquisitive reorganizations under the 1986 Code/83/ and the elective deemed asset acquisitions provisions contained in Section 338. These forms of acquisitions would be replaced with the QA, which can be either a QAA or a QSA. Acquisitive transactions which are not QAAs or QSAs will be taxed at the corporate level under the normal rules of Subchapter C./84/

A QAA includes (1) any statutory merger or consolidation and (2) the acquisition by the acquiring corporation of at least 70 percent of the gross fair market value and at least 90 percent of the net fair market value of the target's assets in which the transferor (target) corporation distributes, within twelve months of the acquisition date all of its remaining assets, other than assets retained to meet claims, to its shareholders or creditors./85/ A QAA thus encompasses "A" and "C" reorganizations as defined in the 1986 Code.

A QSA is defined as the acquisition by an acquiring corporation of control of a target corporation during a 12-month period. Control is defined as at least 80 percent of the total number of shares of each class of stock other than nonvoting stock which is limited and preferred as to dividends./86/ QSAs thus encompass "B" reorganizations under the 1986 Code. In any QAA or QSA, the acquiring corporation is deemed to have made a QSA with respect to any direct subsidiary of the target.

Thompson notes that the present statutory definitions of triangular and reverse triangular (subsidiary) mergers are in essence codified and broadened in the provision for multi-corporation QAAs and QSAs./87/ The Act provides that an acquisition of stock or assets of the target by more than one member of an affiliated group is treated as an acquisition by one corporation for purposes of determining whether there is a QA and for such other purposes as will be specified in the regulations.

The Act states that the QA approach is a much more rational and logical approach to determining which acquisitive transactions are eligible for tax-free treatment at the target corporation, target shareholder and security holder levels than the hodge-podge or alphabet soup of statutory definitions of tax-free acquisitive reorganizations under current law./88/ The QA approach would eliminate many of the complex asset and transactional consistency issues for Section 338 transactions under current law./89/ In testimony on the Preliminary Staff Proposals, Roche, a tax lawyer, stated that the fact that "A", "B", "C" and the various triangular reorganizations will be taxed under similar rules will do much to simplify and rationalize the tax law./90/

In testifying on the Preliminary Staff Proposals, Edward Delaney, Chairman of the Section of Taxation of the American Bar Association (ABA), stated that the ABA Tax Section has long been concerned that the rules governing when corporate acquisitions qualify for tax-free treatment are unnecessarily complex and often distinguish between essentially similar transactions based on technicalities of form rather than differences in economic substance. Delaney stated that the ABA Tax Section was generally sympathetic to a tax regime under which the legal form of a particular acquisition transaction does not determine its tax consequences./91/

Leon Nad, testifying on the Preliminary Staff Proposals for Price Waterhouse, noted that many of the present complexities in the definitional approach of Section 368 arose because of hastily drafted additions to the statute. Nad expressed support for more uniform statutory definitions of various types of acquisitive transactions eligible for tax-free treatment at the corporate level. Nad also stated that the absence of final regulations under Section 368(a)(2)(E) (reverse subsidiary mergers), more than a decade after its enactment, forcefully illustrates the need for comprehensive statutory definitions of those transactions eligible for tax-free treatment./92/

A representative of Deloitte Haskins and Sells testifying on the Preliminary Staff Proposals stated that although the acquisition proposals will not result in a simplification of the tax law/93/ they would provide a more integrated set of rules for all incorporations and reorganizations which would do much to simplify and rationalize Subchapter C. The firm noted that the present tax law for reorganizations is flawed because it is not rational for the law to allow such radically different types of consideration for economically similar acquisitive transactions and because the tax-free incorporation rules and tax-free acquisitive reorganization rules do not mesh well, a situation which can cause anomalous results./94/

In combination with the elimination of the judicial doctrines as prerequisites for QA status in Proposal Two, Proposal One does much to eliminate differences in types of consideration which can be used, amount of assets or stock of the target corporation which must be acquired, differences in pre- and post-transaction activities allowed, potential overlaps between the various types of tax-free acquisitive reorganizations and between various notions of asset and transactional consistency, the categorical distinctions between various types of acquisitive transactions defined in the current law, and the necessity of statutory, judicial, and administrative safeguards so that the tax-free treatment for QAs will not be abused by taxpayers.

The interplay of the current statutory definitions for tax-free acquisitive reorganizations and judicial doctrines as well as the interplay and discontinuities between various types of acquisitive transactions have been criticized as lacking horizontal equity, being without any tax policy justification, and causing many tax compliance and tax planning problems for taxpayers, their advisers, and the Service./95/

In conjunction with the elimination of the judicial doctrines, the Act would attempt to resolve many of the continuing problems under current law which result because the statute itself does not contain a complete description of transactions which are eligible for tax-free treatment. Many commentators feel it is particularly important for the statute to be complete in a self-assessing tax system./96/

The tax literature provides much support for eliminating the hypertechnical statutory definitions for what are, in most cases, economically similar transactions. The 1982 ALI Study states:

> There is widespread agreement that the present reorganization definition is unsatisfactory and needs to be overhauled or replaced./97/
>
> The reorganization definition is almost senselessly complicated in the variety of different criteria it imposes for reorganization treatment on different forms of transactions./98/
>
> Partly because of its complexity, the reorganization definition is frequently uncertain in application. Slight differences in statutory language applicable to different forms of transactions raise possibilities of difference in meaning; conflicts in requirements raise questions about whether the statute means what it says; and so on. Even when its meaning is clear, the definition often makes too much depend on relatively minor differences in corporate form or procedure. In this way the definition often makes it feasible, by modifying a transaction in some way, to alter its reorganization or nonreorganization status. But even if it were desirable to have reorganization status effectively elective, the present definition accomplishes that result in far too complicated and sporadic manner./99/
>
> There is a wide consensus in support of the elimination of the hypertechnical and easily manipulated reorganization and related provisions of the present law, in favor of a simpler, primarily elective choice between a cost and a carryover basis for acquired stock or assets./100/

The Act states the conflicting definitions of transactions constituting tax-free acquisitive reorganizations in the current law in addition to the uncertainty of interaction between the judicial doctrines with each other and with the statutory definitions creates much of the complexity and lack of certainty in the current law./101/ Most commentators agree. Thompson, for example, agrees with the critics who state that the current definitions for tax-free acquisitive reorganizations are much more a result of how the tax law developed rather than the result of Congress attempting to implement a unifying principle. Thompson states:

> There is no tax policy justification for the disparate treatment of boot, continuity of interest, and the 'substantially all' test in the various forms of reorganizations. No one could justify allowing (1) fifty percent boot in a direct merger under section 368(a)(1)(A) and in the forward subsidiary merger under section 368(a)(2)(D), (2) twenty percent boot both in a reverse subsidiary merger under section 368(a)(2)(E) and in certain stock-for-asset acquisitions under section 368(a)(1)(C), and (3) no boot in a stock-for-stock acquisition under section 368(a)(1)(B). Similarly, there is no justification for allowing nonvoting common or preferred stock to qualify for continuity-of-interest purposes both in a direct merger under section 368(a)(1)(A) and in a forward subsidiary merger under section 368(a)(2)(D), but requiring voting stock for continuity-of-interest purposes in each of (1) a stock-for-stock acquisition under section 368(a)(1)(B), (2) a stock-for-asset acquisition under section 368(a)(1)(C), and (3) a reverse subsidiary merger under section 368(a)(2)(E)./102/
>
> Further, it is unthinkable from a tax policy perspective that one would construct a 'substantially all' test for a stock-for-asset reorganization under section 368(a)(1)(C) and for both the forward and reverse subsidiary mergers under sections 368(a)(2)

> (D) and (E), but no such test for the direct merger under section 368(a)(1)(A) or for the direct stock-for-stock acquisition under section 368(a)(1)(B)./103/

Another justification for the elimination of the current statutory definitions for tax-free acquisitive reorganizations is that they are outmoded and outdated conceptions of a "reorganization" based on primitive statutory language and the early judicial decisions in which a single corporation underwent a simple refinancing transaction./104/ Stated differently, certain commentators believe the statutory definitions to be largely irrelevant to today's transactions and do not serve their original purpose of distinguishing taxable sales of businesses from tax-free rearrangements of corporate structures./105/

<u>Proposal Two</u>

> The Act eliminates the following three long-standing common law judicial doctrines which serve as prerequisites to tax-free acquisitive reorganization treatment under current law: continuity of interest; continuity of business enterprise; and business purpose.

Proposal Two has two principal goals. The first is to recognize and admit that the typical "tax-free acquisitive reorganization" executed under current law is really a sale of a corporate business and not a rearrangement of its financial structure or some other rearrangement of corporate or shareholder interests envisioned by the early statutory provisions and judicial decisions. Faber asserts that any observer of today's commercial realities would conclude that it is a "fiction" to treat the target corporation as if it were continued by the acquiring corporation in any meaningful sense./106/ The second goal is to recognize and admit that using these judicial doctrines to distinguish sales and reorganizations has not succeeded and has made the tax law for tax-free acquisitive reorganizations very complex and uncertain.

Proposal Two (along with Proposals Three and Four) eliminates the traditional notions of continuity of interest at the acquiring corporation and the target corporation shareholder and security holder levels. Proposal Two does much to sever the connection between the corporate level and shareholder tax consequences of a QA as compared to a tax-free acquisitive reorganization under current law./107/ The broad definition of a QA in Proposal One coupled with the elimination of the judicial doctrines as prerequisites for QA status significantly expands the number of transactions which can achieve tax-free treatment under the acquisition proposals as compared with current law./108/

One of the overall objectives of the Act is to completely eliminate the judicial conceptions of the category of acquisitive transactions known as "tax-free acquisitive reorganizations." The elimination of each of the three judicial doctrines as a prerequisite for acquisitive transactions being treated as a QA represents a significant change in the explicit and implicit tax policies underlying much of the current federal income tax law applicable to tax-free acquisitive reorganizations and would alter both the tax compliance and tax planning environments.

Proponents of the acquisition proposals believe that eliminating the judicial doctrines would do much to simplify and rationalize the federal income tax laws for acquisitive transactions because neither the taxpayer nor his advisers would have to be concerned about the uncertain boundaries of each doctrine,/109/ the uncertain interactions of each doctrine with each other,/110/ and the uncertain interaction of the definitional and operative provisions of the Code with the judicial doctrines.

Thomas Maletta, testifying on the Preliminary Staff Proposals on behalf of the Tax Executives Institute (TEI), stated that elimination of the continuity of shareholder interest and continuity of business enterprise doctrines would itself constitute significant simplification and reform./111/ In testimony before Congress on the Preliminary Staff Proposals, the Treasury Department stated its agreement with the complete elimination of the continuity of interest and business purpose doctrines./112/ The Treasury Department expressed concern about the complete elimination of the continuity of business enterprise doctrine./113/

In assessing the severity of problems caused by using the judicial doctrines to distinguish sales of business and reorganizations and to protect the integrity of the tax-free acquisitive reorganization provisions, Congress must bear some of the responsibility. In the Committee Reports on the Revenue Act of 1934, for example, Congress encouraged the courts and the Service "to look through the mere form of the transaction into its substance" and to allow tax-free reorganization treatment only when the transaction satisfied both the letter and the spirit of the law./114/

In commenting on the role of the continuity of interest requirement under the 1954 Code, McGaffey and Hunt made comments which are typical of the criticisms in the tax literature for each of the three judicial doctrines:

> Although perhaps simple in concept, the continuity-of-interest requirement presents the practitioners with a formidable set of uncertainties, particularly with regard to the effect of contemporaneous transactions, in terms of planning and structuring acquisitive reorganizations in the kinds of close cases likely to be presented by cash-option mergers and other transactions in which a substantial amount of cash is given. If fact, under the present law, there may be no way to deal with these problems except by building into any such transaction a large "cushion" of qualifying consideration. The advantage of this state of affairs, of course, is to make the tax law a Byzantine profession practiced by a few high priests who are highly compensated because of their ability, first of all, to discover that there is a problem and, second, to develop suitable modifications to resolve the problem that only they can see./115/

The continuity of interest requirement can be broken down into its three aspects: qualitative;/116/ quantitative;/117/ and temporal./118/ Proponents of the acquisition proposals note that each aspect of the continuity of interest doctrine causes significant complexity and lack of certainty for taxpayers and their advisers. Many commentators believe that the continuity of business enterprise requirement/119/ and business purpose requirement,/120/ as stated in the current regulations, do not implement sound tax policies or even the policies and principles underlying the tax-free acquisitive reorganization provisions. Much evidence exists that none of these judicial requirements have been applied uniformly across taxpayers.

Opponents of the acquisition proposals disagree that the lack of clear boundaries and other tax planning problems experienced by practitioners with the judicial doctrines justifies their complete elimination as prerequisites for QA treatment./121/ In testimony on the Preliminary Staff Proposals, representatives of Deloitte Haskins and Sells were opposed to the elimination of the continuity of interest and continuity of business enterprise doctrines because their elimination would move the tax law away from traditional notions of what constitutes a tax-free acquisitive transaction:

> Present law governing corporate reorganizations, as developed over the prior 50 years, is based on a distinction between what constitutes a sale and exchange and what constitutes a continuation of a corporate business in modified corporate form. As such, despite their complexities, the provisions have provided flexibility. The concept of continuity of business enterprise and continuity of shareholder interest are essential elements of that distinction. The problems with the administration of these concepts have been the lack of a statutory definition rather than with the principles themselves./122/

In order to eliminate the reorganization concept contained in current law, to avoid the uncertain boundaries and to provide flexibility for all types of multi-corporate acquisitions, the Act provides no continuity of shareholder interest, continuity of business enterprise or business purpose requirement for a QAA or a QSA. In addition, if a shareholder of the target corporation receives only qualifying consideration, <u>in a transaction which is a QA</u>, the shareholder will receive tax-free treatment regardless of the types of consideration used by the acquiring corporation./123/ The reason most frequently advanced for eliminating these three doctrines is their uncertain boundaries. Even experienced and sophisticated tax practitioners often cannot accurately predict whether the Service or the courts will use one or more of these judicial doctrines to upset an acquisitive transaction structured as a "tax-free reorganization." This uncertainty creates the need for taxpayers to seek advanced rulings on the federal income tax consequences of proposed acquisitive transactions with the attendant increase in costs and complexity. Other commentators point to the uncertainty and lack of predictability caused by the interaction of the judicial doctrines and the statutory provisions as symptoms of the needless complexity of the present body of federal income tax law applicable to tax-free acquisitive reorganizations and the need to eliminate the judicial doctrines as prerequisites for QA status if the tax law is to be made simpler and more rational./124/

Proposal Three

> Under the Act, new Section 365 allows the corporations involved to explicitly elect the corporate level federal income tax consequences of a qualified acquisition. A cost basis or a carry over basis election can be made in connection with a qualified acquisition. These elections determine whether the target corporation will recognize the gain inherent in its assets, whether the acquiring corporation will take a cost or carryover basis for the target's assets, and how the conditional and potential tax liabilities of the target corporation at the time of the qualified acquisition will be handled.
>
> In a cost basis acquisition, the acquiring corporation will take a cost basis in the assets acquired from the target corporation and the target corporation will recognize the gain inherent in each of its assets. In a carryover basis acquisition, the acquiring corporation will take a carryover basis in the assets acquired from the target corporation and the target corporation will recognize no gain. A carryover basis acquisition has essentially the same federal income tax consequences as a tax-free acquisitive reorganization under current law. The tax attributes of the target corporation will carryover to the acquiring corporation in carryover basis acquisitions but will not do so in cost basis acquisitions.
>
> Proposal Three has the following objectives:

1. Recognize the tax law for acquisitive transactions under the 1986 Code is effectively elective/125/;

2. Eliminate the system of transactional electivity which exists under the 1986 Code (i.e., obtaining the desired tax consequences by manipulating the legal form of the transaction and other matters of corporate procedure);

3. Eliminate the economic inefficiencies which result when an acquisitive transaction are structured in a commercially inferior manner in order to achieve the desired tax consequences by separating tax consequences from issues of legal form and corporate procedure to the extent possible;/126/

4. Uncouple the corporate and shareholder and security holder tax consequences of acquisitive transactions;/127/ and

5. Directly link the issues of whether the target corporation recognizes gain, the acquiring corporation's tax basis in the target's assets, and the disposition of the conditional and potential tax liabilities of the target corporation at the time of a qualified acquisition./128/

Proposal Three is based on the objective of "making the tax law less dependent on form, making the tax consequences of transactions less dependent on the skill of the tax lawyer, and making elections more conscious."/129/ The tax regime envisioned by Proposal Three has been described as follows:

> In both the ALI and the Senate Finance Committee Proposal, the repeal of the General Utilities doctrine was to be part of a more generalized revision of the acquisition provisions of Subchapter C. In both proposals, despite the consideration used to carry out the acquisitions, the [acquiring] corporation could elect to take a carry-over basis without any corporate level gain recognition or could elect to take a stepped-up basis by recognizing the gain inherent in assets of the acquired corporation.

> Among the justifications for reform of corporate acquisitions was the belief that the definitional provisions for tax-free reorganizations were complex beyond any justification, inconsistent, and confusing. The proponents of reform believed that making the tax consequences of a corporate acquisition depend on an express election was more reasonable than allowing taxpayers to elect their tax consequences by the form of the acquisition. Requiring taxpayers to shape their transactions correctly to avoid the adverse tax consequences penalized the ill-financed and the ill-advised./130/

The tax literature stresses that the elective corporate level tax regime envisioned by Proposal Three does not change the tax results available under current law but that it does simplify and rationalize the way in which those results can be achieved./131/ Proposals Three and Four have been described by Edward Delaney in the following manner:

> The [Preliminary] Staff proposals would eliminate the requirement of stock consideration as well as other traditional distinctions between taxable and nontaxable corporate acquisitions. Their central concept is that in acquisitions of either a controlling stock interest in, or substantially all of the assets of, a corporation, the parties will be permitted to elect taxable or tax-free treatment of the transaction at the [target] corporate level. The necessary corollary of taxable treatment is that the tax basis of the assets of the acquired company would be stepped up to reflect the fair market value of the assets, whereas in a tax-free transaction, the assets basis would continued unchanged.
>
> Shareholders of the acquired corporation receiving stock in connection with a qualified corporation acquisition would be entitled to tax-free treatment irrespective of whether the transaction is taxable or nontaxable at the corporate level, and irrespective also of whether, or how much, stock is received by other shareholders. Thus, the 'continuity of interest' requirement under present law would be abolished; and the tax treatment of the transaction would

> not be subject to challenge by reasons of pre-acquisition changes in ownership of the acquired corporation's stock, or post-acquisitions dispositions of stock received in the transaction./132/

Proposal Three assumes the repeal of the corporate level nonrecognition provisions contained in the 1954 Code which codified the General Utilities doctrine./133/ Faber has described the acquisition proposals in the following manner:

> Under the [Senate Finance Committee] Staff Report, which built on a study that had been completed a few years earlier by the American Law Institute, a system was proposed in which the corporate parties to a[n] [acquisitive] transaction could elect corporate-level tax treatment without regard to the transaction's [legal] form. Transactions were classified as either cost basis or carryover basis transactions. In cost basis transactions, the target's assets took a new basis equal to the buyer's cost or their fair market value and the target recognized gain on all appreciation, not just on recapture items. General Utilities was repealed. In a carryover basis transaction, the buyer took the target's assets at their old basis and the target did not recognize gain. Shareholder taxation was separated from corporate taxation. A shareholder who received only stock in exchange for his stock in the target corporation was not taxed on any realized gain, regardless of the nature of the consideration received by the other shareholders or the treatment of the transaction at the corporate level./134/

In testimony before Congress in 1983, William Andrews stated:

> The Committee Staff and ALI proposals would eliminate [the various problems associated with the doctrine] by repealing the General Utilities rule itself, substituting the simple, measured general rule that a corporation must recognize gain on any disposition of appreciated property except one in which basis carries over to a corporate transferee. This reformulation would produce enormous simplification, super-

> ceding the present piecemeal exceptions to General Utilities and making it possible to repeal the collapsible corporation provisions. Beyond simplification, this change would produce a much more even-handed application of the income tax and would ameliorate the unproductive bias of current law in favor of corporate acquisitions shaped to take advantage of the exclusion./135/

Proposal Three creates a direct linkage between recognition or nonrecognition of gain by the target corporation when its assets or stock are acquired, how the target's contingent and potential tax liabilities existing at the time of a QA are handled, and the tax basis for the assets or stock in the hands of the acquiring corporation. Proposal Three allows the corporations involved to make these important choices by explicit statutory election.

Many of the problems associated with the present system of transactional electivity and the categorical distinctions between economically similar types of acquisitive transactions illustrate the conflicts between the private law, taxpayer self-interest, and the federal tax law./136/ Using the differing tax categories of alimony and child support which was the subject of Lester v. Comm.,/137/ Fuller concludes that it is virtually impossible to design a taxing system in which the concepts of private law and taxpayer self-interest can be used to create a precise opposition of tax advantages (e.g., a zero-sum game) between the parties. Fuller notes that even in transactions between parties whose economic interests are opposed, the tax advantages and disadvantages of differing characterizations of transactions may not be counter-balanced at all./138/

Because the Internal Revenue Code is not a unified and comprehensive code as compared to the civil codes of those jurisdictions which have codified private law,/139/ Fuller notes the income tax consequences of transactions depend not on the legal transaction which reflects the agreed wills of the parties, but upon the tax law and, if the Service or the courts become involved, an inquiry into the motives of the taxpayer./140/ Fuller also observes that the unresolved relationships between the private law categories and matters of procedure and the tax categories create significant problems for the entire legal system in the United States because the tax laws are superimposed on the general body of private law./141/

According to Fuller, the tax laws undermine the private law categories because, in many transactions, the financial success or failure of the business transaction turns more on obtaining the desirable tax transaction than on the terms of the private law agreement. Fuller states:

> A high progressive tax on incomes creates in the taxing sovereign a direct interest in many and various legal transactions between private parties, particularly those transactions in which gain is realized or loss incurred. Moreover, the sovereign's interest is likely to be opposed to the interests of the parties whose manifested wills shape the nature of the transaction. Since the tax consequences of the transaction depend on the category or classification in

> which the transaction falls, the parties may seek to frame their acts to avail themselves of a private law category which appears advantageous for tax purposes. On the other hand, the taxing authority will desire to reclassify the transaction in order to protect the revenue and to prevent the taxpayer from obtaining a tax advantage not corresponding with what the tax authority regards as the economic reality of the transaction./142/

Fuller's conclusions about the interaction of the private law and tax categories support the elective taxing regime envisioned by Proposal Three:

> Once a rule of tax law is firmly established that the tax consequences of the settlement will be controlled by the explicit designation given by the parties themselves, the precise opposition of tax advantages and disadvantages between the parties may be depended on to make the classification question a matter of negotiation between the parties and their counsel. The income can not disappear, but must be taxed to one party or the other, so that the interest of the sovereign is protected; and the opposition of interests between the private parties permits the private law category to be derived correctly from the external manifestation of their agreed wills. (emphasis added)/143/

The strongest justification for Proposal Three is that until Congress acts to conform the tax treatment of stock and asset acquisitions/144/ the next best approach is to separate the legal form of the acquisitive transaction from its tax consequences by making the corporate level consequences explicitly elective and separating the shareholder level consequences from that of the corporation and from other shareholders (as done in Proposal 4)./145/

In testimony on the Preliminary Staff Proposals, Ronald Pearlman of the Treasury Department supported Proposal Three in part because the 1954 Code provisions which presumably distinguish tax-free reorganizations from other types of acquisitive transactions are in some respects irrational, unduly complex, economically inefficient, and foster tax abuse./146/ Pearlman also stated:

> The principal defect of the present [reorganization] law is that it relies too heavily on form and corporate procedures in determining tax consequences. We agree that it is very difficult to justify the present rules which define and differentiate various types of acquisitive transactions. The [acquisition] proposals reflect the view that similar transactions ought to be treated similarly, and that the tax law ought to be neutral regarding the transaction's form./147/
>
> We agree that, in practice, taxable or tax-free treatment now is generally electable if the parties follow the forms prescribed by the statute and interpretative authorities. That reliance on form, however, tends to reward the well-advised and to trap those who may not be aware of the nuances of the present provisions. We believe the law would be improved if the results of an acquisition were explicitly elective, and did not depend on [manipulating] the form of the transaction. This is what the proposal provides, and the Treasury Department endorses it./148/

Although Proposal Three has been justified by the possibility of whipsaw, i.e., the IRS is whipsawed when different taxpayers take mutually inconsistent positions on the same transaction,/149/ the tax literature does not support the notion that this happens too frequently. In reporting his research on the liquidation-reincorporation doctrine, Westin found that only six cases were decided in the period between 1980 and 1985./150/

The trade-off of basis and gain recognition used frequently for "tax-free" transactions under the Code, e.g., Section 351, Section 1031, Section 102, Sections 721, 722, and 723, and the tax-free reorganization provisions, are at the heart of the Proposal Three. Proposal Three, which allows the acquiring corporation to explicitly elect tax-free treatment by taking a carryover basis in the target's assets, even where the acquiring corporation pays only cash to the target corporation, has been criticized as an unwarranted erosion of the general realization principles of tax law for allowing an undesirable deterioration of the tax base. According to this view, there are no unique or compelling tax policy reasons for allowing the nonrecognition of gain to the target corporation upon a transfer of its appreciated assets where the transaction clearly fails to satisfy the continuity of interest doctrine and other historic notions of a tax-free reorganization./151/

Proponents of Proposal Three argue that the direct trade-off between recognition or nonrecognition of realized gain at the target corporation level and the acquiring corporation's basis in the target's assets without reference to very complex consistency rules (such as those currently used for Section 338 transactions)/152/ establishes the proper connection between these related issues.

Proponents of Proposal Three also argue that allowing the target corporation to elect not to recognize gain in a carryover basis transaction, regardless of the type of consideration used and the legal form of the acquisition, and also allowing the shareholders of the target corporation nonrecognition of gain upon receipt of qualifying consideration from the acquiring corporation does not deviate too far from present law concepts of realization and recognition, is necessary to simplify and rationalize the taxation of acquisitive transactions, and separates the tax consequences from matters of legal form and corporate procedure.

According to this view, allowing nonrecognition of realized gain at the target corporation level when the acquiring corporation takes a carryover basis in the transferred assets is necessary to provide symmetrical treatment and to avoid making the tax law economically inefficient because the target corporation must recognize gain in order for the acquiring corporation to take a stepped-up basis in the target's assets and is no different in concept than the long standing trade-offs of gain recognition and basis noted above.

Proposal Four

> The Act provides that the shareholder level consequences of a qualified acquisition will be determined independently of the corporate level tax consequences and independently of any election made at the corpo-

rate level. In addition, the Act provides that the tax consequences to each shareholder will be determined independently of the tax consequences to other shareholders.

The express purpose of Proposal Four is to correct a conceptual flaw in the current law. The target corporation shareholder and security holder consequences of a QA should not be linked to whether the overall acquisitive transaction satisfies certain tests (e.g., is a tax-free reorganization under the 1986 Code) at the corporate level./153/ The proper linkage (as established by Proposal Three) is between the basis of target assets of the acquiring corporation and the recognition of gain realized by the target corporation./154/

The Act states:

> Current law links the shareholder level tax consequences of a reorganization to the corporate level tax consequences and to the tax treatment of other shareholders in the transaction. This produces a number of anomalous results. For example, a transaction that fails reorganization status at the corporate level (e.g., because a predisposition of assets causes failure of the "substantially all" requirement) will therefore be fully taxable at the shareholder level, even though the shareholders of the target corporation receive all stock in the acquiring corporation. This is contrary to the policy decision that receipt of stock in an acquiring corporation should entitle a target shareholder to tax-free treatment.
>
> As another example, failure to satisfy a shareholder level requirement (e.g., continuity of interest) will make a transaction completely taxable at the corporate level. . . A more rational system would permit the corporate merger to be tax-free [at the corporate level] so long as the acquiring entity obtained only a carryover basis in the assets transferred./155/

The rule that each target shareholder's tax consequences should be determined independently is intended to reverse the much criticized decision in Kass v. Comm./156/ In commenting on Kass, the Act states "no apparent policy reason can be found to justify the linking of the tax consequences of one shareholder of a target corporation to the tax treatment of other such shareholders."/157/

In testimony before Congress in 1983, Ronald Pearlman indicated the Department's agreement with severing the corporate and shareholder level tax consequences of an acquisition:

> We see no necessary connection between the treatment of an acquisition transaction at the corporate level and the treatment of the exchanging shareholder. There is no incongruity between treating the transaction on a nontaxable basis as between the corporate parties and as a taxable, recognition exchange at the shareholder level. Indeed, this result can obtain under present law upon a cash purchase of shares. Similarly, the parties' decision to treat the transaction on a cost basis need not dictate the results to the shareholder. . . . We believe that upon a corporate combination, taxation should not be required of a shareholder who receives a continuing equity interest in the venture. We recognize the argument that, when the Target is significantly smaller than Acquiring, in fact, an exchange for new and wholly different property has occurred on which taxation should result. In this connection, it might be noted that in formulating the 1954 Code, the House of Representatives would have denied tax-free treatment to mergers and consolidations, other than those between 'publicly-held corporations,' unless the shareholders of Target received at least 20 percent of the stock of the resulting corporation. That provision was not enacted in part because of various problems involved in defining a publicly held corporation. We also

believe it is impossible to draw appropriate lines in this area which will meaningfully distinguish a tax-free continuing investment from a taxable sale.

Accordingly, the Treasury Department agrees that, whatever election is made at the corporate level, shareholder treatment should depend on the nature of consideration received. Investments that represent a continuing equity involvement with the assets of the acquired enterprise, such as stock of the Acquiring or its parent, should be received free of tax. Similarly, receipt of consideration other than stock should have tax consequences usually attending that of a distribution by an ongoing corporation to a shareholder./158/

In testimony before Congress on the Preliminary Staff Proposals, a representative the Tax Section of the New York Bar Association expressed its general agreement with Proposal Four:

. . . [we] generally agree that the treatment of shareholders should be divorced from the treatment of the corporations that are parties to the acquisitions, that whether there is a carryover or cost basis for the assets of the acquired corporation should be determined by a simple election and should not depend on the form of the acquisition or the consideration, and that shareholders should be given nonrecognition treatment when they receive stock from a corporation that is a party to the acquisition, regardless of the form of the acquisition or of the consideration received by other shareholders. These proposals, based on an extensive study over a period of years, are sensible./159/

Leon Nad noted that the Preliminary Staff Proposals do not completely uncouple the corporate and shareholder level tax consequences of a qualified acquisition:

The Staff Proposals state that shareholder treatment would be determined independently of corporate level nonrecognition. <u>This is not wholly accurate</u>. A shareholder in a corporation participating in an asset acquisition would be entitled to nonrecognition upon receiving stock in the acquiring corporation,

> but only if there were a 'qualified acquisition' (i.e., an acquisition of substantially all of the target corporation's assets).
>
> Presumably, under the Staff Proposal, the corporate level consequences of failing the substantially all test would be to transmute any carryover basis acquisition into a cost basis acquisition. However, it seems overly harsh to us to require a tax from shareholders of the target who took stock in the acquiring corporation in reasonable anticipation of nonrecognition treatment. The statute should allow nonrecognition to any such shareholder so long as the corporate parties had a reasonable basis to assume that substantially all the target assets had been acquired even though they may have been technically mistaken. (emphasis added)/160/

Thompson describes the tax consequences of a QAA as follows:

> In a QAA, the target has nonrecognition treatment and the acquiring corporation takes a carryover basis in the target's assets unless a cost basis election ("Cost Election") is made. If a Cost Election is made, the target recognizes gain and loss with respect to its assets and the acquiring corporation takes a cost basis in the assets acquired. However, even if a Cost Election has been filed, an acquiring corporation can elect carryover basis treatment for 'unamortizable intangibles,' such as goodwill acquired from the target, in which case the target does not have taxable gain on the transfer of such intangibles./161/

Thompson describes the tax consequences of a QSA as follows:

> In a QSA, the target corporation (and each target subsidiary) takes a carryover basis in its assets unless a Cost Election is made with respect to such corporation. If the Cost Election is made with respect to the target or target subsidiary, the corporation that makes such an election recognizes gain with respect to its assets and the basis of such assets is stepped up to fair market value. Thus, in contrast, to the antiselective provisions of current section 338, there is complete selectivity under the 1985 SFC [Senate Finance Committee] proposals. The

> apparent reason for allowing this selectivity is that a corporation will have complete recognition with respect to its assets at some point in time. The acquiring corporation takes as its basis in the target's stock the net adjusted basis of the target's assets. Thus, if a Cost Election is not made, there will be a difference between the amount the acquiring corporation paid for the target's stock and its basis in such stock. There are special rules to take account of any such difference./162/

Thompson describes the tax consequences of a QA to the target shareholders and stockholders as follows:

> In any QAA or QSA the target's shareholders receive nonrecognition treatment with respect to the extent they exchange their target stock for stock of the acquiring corporation or any of its affiliates (the "acquiring group"), or exchange securities of the target for securities of an equal principal amount of any member of the acquiring group. Thus, the basic nonrecognition rule of section 354 is retained. Also, as in the case under current section 356, the target's shareholders have gain recognition on the receipt of other property (i.e., boot), which includes the fair market value of the excess principal amount of securities received./163/
>
> The 1985 SFC also resolves the current dispute over how to determine whether the receipt of boot 'has the effect of the distribution of a dividend.' The Proposals's dividend equivalency test is made by treating the transaction as if the target shareholders had received nothing but stock of the acquiring corporation and, immediately after the acquisition, the acquiring corporation redeemed a portion of its stock in exchange for the boot actually received by the shareholders./164/

In order to eliminate the tax-free reorganization concept of current law, to help avoid the uncertain boundaries, and to provide flexibility for all types of multicorporate acquisitions, there is no continuity of shareholder interest, continuity of business enterprise or business purpose requirement for a QAA or a QSA./165/

Thus if a shareholder of the target corporation receives only qualifying consideration, <u>in a transaction which is a QA</u>, the shareholder will receive tax-free treatment regardless of the types of consideration used by the acquiring corporation, regardless of the consideration received by any other shareholder and regardless of any elections made at the corporate level.

Need for Comprehensive Tax Reform

In enacting the Revenue Act of 1934, Chairman Doughton of the House Ways and Means Committee asserted:

> There are three fundamental principles in taxation--namely, equity, consistency, and certainty--and it has been the purpose in drafting this bill to keep these fundamental principles in mind./166/

Based on the existence of the problems discussed in this Chapter, it appears that the current tax law for tax-free acquisitive reorganizations and other types of acquisitive transactions is in need of comprehensive tax reform. Many commentators believe the tax law does not implement the principle of horizontal equity because economically similar acquisitive transactions are categorized as reorganization and nonreorganization transactions and because not all taxpayers can engage sophisticated tax advisers to manipulate the legal form of acquisitive transactions and other matters of corporate procedures to take advantage of the differing tax consequences for economically similar acquisitive transactions.

Many commentators believe the tax law does not implement the principles of consistency and certainty because the law is so complex and makes the tax consequences of acquisitive transactions depend on relatively minor differences in legal form and matters of corporate procedure. The Treasury Department generally supports the acquisition proposals:

> primarily because they will bring consistency and symmetry to corporate transactions, which we do not believe is present in current law, and will minimize the significance of form as is present in current law./167/

As discussed in Chapter IV of this Study, reform of the provisions of the Internal Revenue Code dealing with acquisitive transactions must be approached cautiously in order not to interfere with the operation of securities markets/168/ and in order not to leave the tax law in a state of further confusion and disequilibrium./169/ Ronald Pearlman noted that because the scope of the Subchapter C Revision Act, including the acquisition proposals, is very broad and represents enormous changes in the 1954 Code, the Act's provisions would affect every corporation and every shareholder to some extent:

> The rules of corporate taxation are an integrated whole. If changes are made to certain of the basis provisions, for example, the rule of <u>General Utilities</u>--these changes will reverberate throughout the system. Some provisions previously thought necessary to prevent abuse may no longer be relevant; others may well be redrawn and strengthened. Accordingly, we believe that a fundamental restructuring must take into account all collateral consequences./170/

Reform of the tax provisions applicable to acquisitive transactions must also be approached cautiously because of differing perceptions of the importance of simplicity and certainty. In testifying on the acquisition proposals, for example, a representative of the American Institute of Certified Public Accountants stated:

> . . . complexity is not the bane of the corporate tax rules, uncertainty is. While the existing rules [applicable to acquisitive transactions] may be complex, the complexity is of long standing and judicial and administrative precedent over a sixty year period has refined the rules to the point where tax consequences can generally be predicted with reasonable certainty.
>
> In contract, the Act will create scores of interpretative questions, new definitions, and unintended results without the benefit of regulations, rulings and judicial precedent. The importance of professional advice and the benefits inuring to the well advised will not be reduced by the Act./171/

Chapter IV: Evaluation of Acquisition Proposals in the Context of Comprehensive Tax Reform Efforts

Introduction

The tax and other relevant literature document the existence of fundamental tax policy and related technical problems for acquisitive transactions broadly defined./1/ Studies of Subchapter C and of acquisitive transactions performed by the American Institute of Certified Public Accountants (AICPA),/2/ the American Law Institute (ALI),/3/ and the staff of the Senate Finance Committee/4/ as well as Congressional hearings on tax reform proposals/5/ all indicate the need for comprehensive tax reform/6/ in the acquisitive transactions area of the tax law. The Subchapter C Revision Act of 1985 (the Act) recommends a number of major changes in the taxation of corporate-shareholder transactions. The Act recommends four specific changes for acquisitive transactions (the acquisition proposals) which are the subject of this Study. The tax literature contains extended discussions of the need for tax reform of acquisitive transactions/7/ and detailed descriptions of the acquisition proposals./8/

This Chapter includes an evaluation of the acquisition proposals in the context of comprehensive tax reform efforts in the United States using traditional tax policy criteria./9/ The major tax policy issues and problems for acquisitive transactions, the tax policy premises of the Internal Revenue Code of 1986 (1986 Code) for corporate-shareholder transactions and for acquisitive transactions,/10/ and the continuing relationship of the General Utilities doctrine and the acquisition proposals will be discussed in detail./11/ Comprehensive tax reform efforts in the United States which culminated in issuance of Treasury I,/12/ Treasury II,/13/ enactment of the Tax Reform Act of 1986 (TRA of 1986),/14/ and enactment of the Revenue Act of 1987/15/ will be examined. The generally accepted major goals of comprehensive tax reform efforts, a contrary opinion,/16/ and the related subgoals of tax reform efforts for acquisitive transactions will also be presented. Reactions to the acquisition proposals and reactions to each specific proposal as reflected in the tax literature and the Congressional hearings on the acquisition proposals will be discussed and analyzed./17/

Finally, each acquisition proposal will be evaluated based on the major goals and subgoals of recent comprehensive tax reform efforts in the United States. Appendix B contains a summary of recent empirical evidence on the effects of the federal income on acquisitive transactions.

Economic Importance of Acquisitive Transactions

Most commentators agree with the statement that "since the latter decades of the nineteenth century, corporate formations and corporate mergers have played a major role in the growth and development of the United States economy."/18/ No doubt they will continue to do so.

There is no question that appropriate and intelligent use of the tax-free reorganization provisions of the Code has been beneficial to well-advised taxpayers. Sommerfeld observes:

> The fact that corporate reorganizations can proceed as nontaxable exchanges has had a tremendous impact on our economy. In the 1960s, in particular, corporate stocks and securities almost became a second form of money. Stock and securities were as good as money only because they could, under the right circumstances, be exchanged tax-free. Empires were built, and often lost, through corporate mergers and acquisitions alone. Very little of this merger activity would have been possible had the tax laws not provided nontaxable exchange opportunities. If a corporation or its shareholders had to recognize all prior appreciation in value for income tax purposes before proceeding with a corporate reorganization, reorganizations would be economically impractical./19/

Developments in the 1980s indicate that acquisitive transactions have become an even more important and central theme of the American economy. A principal reason for Congressional concern about the appropriateness of tax and other federal laws applicable to acquisitive transactions is that during calendar year 1984 publicly-announced acquisitive transactions involving at least $500,000 and the transfer of ownership of ten percent or more of a company's assets or equity amounted to approximately $122 billion./20/

Tax Reform Act of 1986

The major goals of comprehensive tax reform efforts in the United States and the subgoals of efforts to reform the taxation of acquisitive transactions are discussed in detail in a subsequent section of this Chapter. The overall objective of comprehensive tax reform efforts in the United States is to reduce the economic inefficiency of the federal income tax laws by moving toward a pure income tax system./21/ The comprehensive tax reform effort accepts the reality that any income tax system will cause economic inefficiencies because the tax system affects the costs and returns of engaging in most types of activities and is therefore likely to cause a misallocation of resources as compared with their most efficient uses in a no tax world./22/ The comprehensive tax reform effort also accepts the reality that the frequency and complexity of tax law changes in the United States since World War II/23/ cause economic dislocations and inefficiencies, provide windfalls to certain industries,/24/ impose particularly harsh costs and burdens on the small business sector in the United States,/25/ and cause a number of problems for taxpayers and their professional advisers./26/

A pure income tax system defines gross income broadly in order to allow the imposition of relatively low and uniform marginal tax rates. Broadening the tax base is felt to have a number of significant benefits: eliminating many sources of misallocation of resources; allowing the imposition of relatively low tax rates; and improving the overall equity of the tax system./27/ Because no one can accurately predict or measure the distortions and economic inefficiencies caused by a tax system and because there is general agreement that lower marginal tax rates cause less economic inefficiency than higher marginal tax rates, broadening the tax base and reducing marginal tax rates are two of the most fundamental goals of comprehensive tax reform./28/

The comprehensive tax reform effort accepts the reality that erosion of the tax base necessitates the imposition of higher marginal tax rates and that imposition of high marginal tax rates causes a number of economic and political problems./29/ Compared to the 1954 Code, the enactment of a pure income tax system would reduce the variation in effective tax rates on various industries as well as the variation in effective tax rates on various types of assets and financing arrangements,/30/ improve incentives for saving and investment,/31/ and reduce incentives for current consumption of income./32/

James Baker, Secretary of the Treasury Department, asserts that any effort to reform the taxation of corporations and shareholders should implement the following "basic principles" of taxation: broadening the tax base; imposing low marginal tax rates; making the tax law as economically neutral as possible; making the tax law as simple as possible; and providing fair and orderly transition rules when major changes in the tax law are enacted./33/ Businessmen generally agree that the tax law for corporate-shareholder transactions should be based on the following tax policy principles: fairness; neutrality; economic efficiency; stability; and simplicity./34/

Many commentators have characterized the TRA of 1986 as one of the most sweeping changes in the Internal Revenue Code since its enactment./35/ Steuerle, for example, asserts that the TRA of 1986 constitutes a major step forward in both federal income tax and economic policy because the effects of a number of long-standing sources of economic inefficiency in the federal income tax laws are eliminated or significantly reduced./36/ Steuerle notes, however, that the TRA of 1986 did not address many of the problems caused by subjecting corporate income to an essentially unintegrated double tax regime (e.g., encouraging the substitution of debt for equity in corporate financial structures and providing significant disincentives to conduct profit-seeking business enterprises in corporate form)./37/

Pechman states that although Congress followed the predictable pattern and paid lip service to the goals of simplifying the tax laws and reducing economic inefficiencies caused by the imposition of an income tax, the TRA of 1986 enacted a host of very technical provisions that reach new levels of complexity./38/ Simmons characterizes the enactment of the TRA of 1986 as one of intense competition to protect the economic interests of different groups with little focus on implementing any comprehensive theory of taxation./39/ Feldstein states that in enacting the "revenue-neutral" TRA of 1986, Congress make no attempt to estimate the distributional consequences of the major changes in corporate tax law on individual taxpayers./40/ Stiglitz and Wolfson assert that the TRA of 1986 significantly reduces incentives for taxpayers to operate profit-seeking businesses in corporate form and will not achieve its overall objectives of restoring the progressivity of the individual income tax system and increasing the yield of the corporate tax system./41/

Based on the suggestions in Treasury I and Treasury II and the comprehensive tax reform effort generally, one of the major goals of the TRA of 1986 was to make the tax law less economically inefficient. Several commentators state the complexity of the corporate tax law in the 1986 Code (e.g., the new corporate alternative minimum tax provisions) coupled with substantial increases in corporate tax liability caused, for example, by the repeal of the General Utilities doctrine will inevitably increase the importance of income tax considerations in corporate decision making./42/

The 1987 Report of the Council of Economic Advisers asserts:

> The Tax Reform Act of 1986 is perhaps the most important reform of the Federal income tax since its inception in 1913. . . . Tax reform, the administration's number one domestic priority for the past several years, has been accomplished. The Tax Reform Act of 1986 significantly lowers tax rates and will decrease tax-induced distortions in private economic decisions./43/

The principal reasons for the assertion that the TRA of 1986 enacted comprehensive tax reform include:

1. An efficient tax system imposes relatively low and unvarying marginal tax rates. Low marginal tax rates minimize the economic inefficiency of an income tax system and will have minimal effects on investment and consumption decisions. The TRA of 1986 imposes marginal tax rates on all taxpayers which are approximately equal to the marginal tax rates imposed in 1965./44/

2. One important benefit of the imposition of low marginal tax rates is to reduce incentives for taxpayers

to engage in tax avoidance and tax evasion. Widespread tax avoidance efforts often lead to an economically inefficient allocation of resources./45/ The TRA of 1986 limits the benefits of tax shelter investments both directly (e.g., by imposing the passive loss rules) and indirectly (e.g., by eliminating lower tax rates for long-term capital gains, lengthening of depreciation periods, limiting deductions for investment interest expense, and lowering marginal tax rates)./46/

3. The TRA of 1986 will significantly improve the long-run economic performance of the United States economy due to a more economically efficient allocation of resources./47/

4. The TRA of 1986 will make the individual income tax system more progressive and will improve horizontal equity by substantially reducing the variation in taxes paid by taxpayers with the same amounts of real economic income./48/

Many commentators do not believe the changes made in the Internal Revenue Code by the TRA of 1986 enacted comprehensive tax reform generally/49/ or for acquisitive transactions broadly defined. In commenting on the 1986 Code, Joseph Pechman has observed:

> The law permits the reorganization of corporations through acquisitions, mergers, divisions, and other arrangements without recognizing gains and losses as a result of the transaction. The purpose is to permit corporations to arrange their affairs in a flex-

> ible manner without incurring tax liability in the process. But the provisions are highly complicated and arbitrary, with the result that the unwary or ill-advised may be subject to large amounts of tax for purely procedural rather than substantive reasons, while others escape paying taxes that ought to be paid. The 1986 Act eliminated the opportunities that were previously available to corporations to distribute appreciated property free of corporate tax. However, further legislation is needed to harmonize and simplify the statutory provisions relating to tax-free reorganizations./50/

The TRA of 1986 repealed the 1954 Code provisions which codified the General Utilities doctrine but did not make other changes recommended in the Subchapter C Revision Act, including the enactment of the acquisition proposals. Several commentators believe that repeal of General Utilities was the highest profile item in the TRA of 1986 and represented the most important structural change for corporate-shareholder taxation./51/ Leduc and Gordon note, however, that the decisions to repeal General Utilities and not to enact the acquisition proposals were based largely on criteria other than traditional tax policy objectives:

> . . . [the repeal of General Utilities] was not based on a theoretical premise nor by a widespread view that the ability to liquidate a corporation and secure a step up in basis in its assets at the [acquiring] corporate level was inherently abusive. Revenue considerations, apparently, were decisive. . . . in the case of the [acquisition] proposals, no positive revenue was to be generated and no abuse was to be foreclosed. The . . . provisions went unenacted./52/

Many commentators believe the Treasury Department and Congress should have evaluated the General Utilities doctrine and the acquisition proposals as the single integrated legislative package envisioned by the ALI and the staff of the Senate Finance Committee./53/ Leduc states there were important political and substantive reasons why consideration of General Utilities and the acquisition proposals should have not been separated. Leduc and other commentators believe that revenue needs will prevent Congress from liberalizing the treatment of acquisitive transactions under the 1986 Code by expanding the number and type of transactions eligible for tax-free treatment at either the target corporation or target shareholder and security holder levels. The crux of the political argument is that the acquisition proposals are very likely to be revenue-losers in the post-General Utilities world because few qualified acquisitions will be coupled with a cost basis election. Although the repeal of General Utilities was clearly a revenue-gainer, the probability of Congress enacting the acquisition proposals by themselves is remote./54/

Enactment of the acquisition proposals will liberalize the 1986 Code by making the immediate recognition of realized gain by the target corporation and its shareholders and security holders less likely. The complete repeal of the continuity of interest doctrine, the continuity of business enterprise doctrine, and the business purpose doctrine will allow more acquisitive transactions to be eligible for tax-free (i.e., qualified acquisition (QA)) treatment as compared to the 1986 Code. In addition, the corporate and shareholder tax consequences of a QA are uncoupled to a much greater extent than are tax-free acquisitive reorganizations under the 1986 Code. Thus the receipt of stock of the acquiring corporation by target shareholders will much more likely result in tax-free treatment than under the 1986 Code./55/

Aside from the severe political problems associated with proposing and enacting revenue-losing tax reforms, Leduc identifies a number of substantive tax policy reasons why Congress should not have evaluated the acquisition proposals and General Utilities as separate tax policy issues:

> If General Utilities were not repealed, but express electivity (and its attendant shareholder recognition rule) were adopted, then corporations could be sold in cost basis acquisitions for stock, without imposition of tax at either the corporate level (except for recapture and similar items) or the shareholder level. That result is obviously more favorable than present law [the 1954 Code] which requires shareholder level recognition of gain as the price for a corporate level step-up in basis. . . . Is there a theoretical reason for that result? None is apparent. Such a rule would provide an incentive for acquisitions because the tax benefits of stepped up basis for assets would often make a corporation more valuable in the hands of an acquiring person than in the hands of its current owners. That bias could result in inefficient allocation of resources and undesirable economic concentration. Thus, the enactment of the express electivity rules without the enactment of the repeal of General Utilities appears undesirable.

> On the other hand, if General Utilities were repealed without the enactment of the express electivity rules for corporate acquisitions, undesirable additional pressure would be put on the current reorganization definitions. In particular, because a section 338 election would generally be less viable, it would probably be more important to secure reorganization status so as to defer shareholder tax. In conclusion, therefore, the proposal to enact the elective acquisition regime without also repealing General Utilities appears theoretically misguided and politically naive./56/

Not all commentators are so pessimistic about the future of the acquisition proposals. Yin believes that the repeal of General Utilities coupled with other changes made in the TRA of 1986 may herald the beginning of another stage in the development of Subchapter C:

> Combined with the elimination of the preferential treatment of long-term capital gains and the enactment of a top corporate tax rate higher than the top individual rate, the repeal of General Utilities opens up the way to a major clean-up in Subchapter C and related provisions, potentially including the repeal of the collapsible corporation rules, repeal of the accumulated earnings and personal holding company taxes, substantial revision of Section 355, and perhaps even the repeal of much of Section 338. Moreover, it makes feasible the implementation of the proposals to revise the reorganization provisions [the acquisition proposals]. The Treasury, heretofore a reluctant player in efforts to revise Subchapter C, has now been pushed, appropriately, to center stage by a congressional directive that it conduct a study of Subchapter C reform. Its report on this study, due by January 1, 1988, should serve as a blueprint for further legislative reform./57/

The TRA of 1986 did not eliminate the categorical distinctions between various types of economically similar acquisitive transactions and continued the system of transactional electivity which existed in the 1954 Code. The TRA of 1986 did not attempt to separate the tax consequences of acquisitive transactions from their legal forms and other matters of corporate procedure. The TRA of 1986 exacerbated the differences in tax consequences for acquisitions of a controlling interest in target corporation stock and acquisitions of all or substantially all of the assets of a target corporation, did little to address the resulting tensions and discontinuities between taxable and tax-free acquisitive transactions,/58/ and did much to upset the rough equilibrium between the corporate and individual tax systems that existed under the 1954 Code./59/ Many commentators believe that while TRA of 1986 made Subchapter C much more complicated, it did not make the tax law more horizontally equitable or more economically efficient. The TRA of 1986 continues to elevate legal form over economic substance, to reward well-financed and well-advised taxpayers, and to encourage certain types of transactions (e.g., carryover basis acquisitions) while penalizing others (e.g., taxable acquisitions)./60/

<u>Approach to Evaluating Acquisition Proposals</u>

Neither the federal income tax policy nor technical provisions of the 1986 Code applicable to acquisitive transactions/61/ can be intelligently assessed in a vacuum. Any individual or organization advocating major change in public policies must be very sensitive to the political realities and settings/62/ and the underlying philosophy of the federal tax system./63/ The task of investigating and evaluating the acquisition proposals involves careful study of tax policy and related technical issues./64/ In commenting on the need to integrate consideration of technical issues and general policy issues in the comprehensive tax reform effort, the Joint Committee on Taxation states:

> One of the reasons often expressed for comprehensive tax reform is that the system has become too intricate and that the pace and complexity of recent tax legislation are too much for even sophisticated tax advisers to deal with.
>
> Under a broadly based income tax system, the technical rules governing corporate reorganizations, partnerships and trusts, and activities that involve the time value of money would still need attention. Although such issues tend to be less significant in a system with lower marginal tax rates, the associated rules may nevertheless be complex./65/

Interrelated issues such as the federal and state regulation of the securities markets,/66/ particularly the takeover process,/67/ antitrust policy,/68/ corporate conduct,/69/ corporate governance,/70/ management prerogative,/71/ organizational structure of corporate entities, and corporate finance/72/ must also be considered. The recent wave of corporate takeovers, both friendly and hostile,/73/ their size, the novel offensive and defensive tactics employed, and the justifications given for acquisitions/74/ have caused Congress, top level corporate managers, and commentators of various persuasions to focus on the continuing appropriateness of the current federal income tax laws and other federal laws applicable to acquisitive transactions./75/ The Joint Committee on Taxation has urged Congress not to enact narrow and technical tax legislation addressing only the most glaring symptoms of the current megamerger boom without identifying the underlying causes of tax-motivated or tax-supported mergers because the primary result of such "reforms" may be the prevention of many economically desirable acquisitive transactions./76/

Resolution of the tax policy issues and conflicts discussed throughout this Study will not be easy. The inability of policy-oriented or empirical research to explain why acquisitive transactions occur and the extent to which the tax law influences decisions to enter into such transactions make it difficult to argue persuasively for the enactment of the acquisition proposals or any other tax reform proposals for acquisitive transactions./77/

Major Tax Policy Issues and Problems for Acquisitive Transactions

A number of fundamental tax policy issues and problems must be addressed and resolved in order to comprehensively reform the federal income taxation of acquisitive transactions broadly defined. The resolution of many of these issues is related to provisions of the tax law (e.g., estate and gift taxation) and closely related to the income tax provisions applicable to corporate-shareholder transactions. Prior tax reform proposals and the acquisition proposals take the position that reforming the tax law for acquisitive transactions can most effectively and efficiently be accomplished in the framework of Subchapter C./78/ Although many commentators assert that the imposition of a separate corporate level income tax continues to cause a number of economic problems/79/ and is not needed in a pure income tax system,/80/ the acquisition proposals assume the continuation of a two-tier income tax.

The principal tax policy issues and problems for acquisitive transactions are summarized below:

1. Is there a class of acquisitive transactions which constitutes readjustments or rearrangements of a corporate business as distinguished from the sale of corporate businesses, the sale of substantially all of the assets of the business, or the sale of a controlling interest in the stock of the corporation conducting the business?

   a. How should readjustments and rearrangements be distinguished from sales of assets or stock?

   b. What role should the legal form of the transaction play in making this distinction?

   c. Are the traditional continuity of shareholder interest and continuity of business enterprise doctrines necessary to make this distinction?

d. Is the traditional business purpose doctrine necessary to make this distinction?

e. If both the legal form of the transaction and the judicial doctrines are needed to make this distinction, how should they relate to each other? What economic inefficiencies are introduced by predicating corporate or shareholder and security level tax treatment on either the legal form of the transaction, the judicial doctrines, or a combination of the two?

2. Are there overriding tax policy reasons why the tax law should provide tax-free treatment at either the target corporation or the target shareholder and security holder levels for transactions which are readjustments or rearrangements of corporate businesses?

   a. Is the argument that tax-free treatment should be provided at both the corporate and shareholder and security holder levels to avoid interfering with business planning, operations, and judgments valid?

   b. Is the argument that economic efficiency requires tax-free treatment at both the corporate and shareholder and security holders levels valid?

   c. Is the argument that the tax law should stimulate economically and socially desirable readjustments or rearrangements of corporate businesses valid?

   d. Is the argument that the lack of formal integration of the corporate and individual income tax systems necessitates providing tax-free treatment for this type of acquisitive transactions valid?

   e. Are there important economic and social reasons for providing tax-free treatment or readjustments or rearrangements of small or closely-held businesses?/81/

3. Assuming the tax law should provide tax-free treatment at the corporate or shareholder and security holder levels for acquisitive transactions involving the readjustment or rearrangement of a

corporation, how should this policy be implemented in the statutory provisions?

a. Should the categorical distinctions between the types of acquisitive transactions in the 1954 and 1986 Codes be repealed and replaced with a more functional, rational, and broader class of economically similar transactions eligible for tax-free treatment?

b. Should the transactional electivity of 1954 and 1986 Codes be repealed and be replaced with a system of explicit electivity of corporate level tax consequences?

c. How should the conditional and potential tax liabilities of the target corporation at the time of an acquisition be handled?

   i. Settled whenever appreciated corporate assets leave one economic group (i.e., enact the strong form of taxation)?

   ii. Settled whenever appreciated corporate assets leave one economic group and receive a stepped-up (fair market value) basis in the hands of the transferee (i.e., enact the weak form of taxation)?

d. Should there be an explicit and direct trade-off between the acquiring corporation's tax basis in the target's assets and the disposition of the target corporation's conditional and potential tax liabilities?

   i. Is an elective regime in which the acquiring corporation takes a cost basis in the target's assets if the target corporation recognizes gain and pays tax on all appreciation in value at the time of the transaction or takes a carryover basis in the target assets without the target's payment of tax an equitable and economically efficient means of handling these related issues?

   ii. On a present value basis?

iii. What sort of consistency rules are needed?/82/

e. To what extent should the tax consequences for the target corporation and target shareholder and security holders be linked?

   i. Should there be some connection between qualification for tax-free treatment at the target corporation level and tax-free treatment at the target corporation shareholder and security holder levels?

   ii. If not, what events constitute a tax-free exchange at the target corporation shareholder and security holder level?

f. How can corporate and noncorporate taxpayers be prevented from abusing the tax-free treatment provided for rearrangements or readjustments of corporations but not for sales of corporate businesses, sales of substantially all the assets of a corporation, and sales of a controlling interest in the stock of a corporation operating the business?

   i. What types of extrastatutory safeguards are necessary?

   ii. Is the liquidation-reincorporation doctrine relevant?

<u>Tax Policy Premises of Current Tax Law</u>

<u>Corporate-shareholder transactions</u>

Faber/83/ has identified four fundamental tax policy premises applicable to corporate-shareholder transactions:

1. A separate level of income tax should be imposed on the taxable income of regular (C) corporations./84/ Shareholders should only be subject to taxation when the corporation distributes dividends to them. There should thus be a full two-tier income tax structure in which both corporations and shareholders are subject to taxation on

the taxable income of what is basically one business enterprise./85/

2. A shareholder's interest in corporate stock is a separate and distinct asset with its own independent characteristics./86/ The tax consequences of a sale or exchange of corporate stock should not depend on the nature of the underlying corporate assets./87/

3. If the form of a transaction reflects its substance, the form should control the tax consequences. Particularly for transactions structured as tax-free reorganizations, Faber notes that the current law deviates in many substantial ways from this premise by forcing taxpayers to follow many of the fictions of current law (e.g., that the typical "tax-free reorganization" is a "rearrangement" or "readjustment" of assets and not a sale and the assumptions underlying the judicial doctrines/88/), and by allowing both statutory electivity (e.g., Section 338) and transactional electivity (e.g., for acquisitive transactions generally)./89/

The 1982 ALI Study describes the elevation of legal form over economic substance that pervades Subchapter C:

> . . .[if an acquisitive transaction is not a tax-free reorganization] its tax treatment [under the 1954 Code] is governed to a large extent by judicially elaborated conceptions of what constitutes a realization of income and continuity of corporate legal identity.

In this conceptual scheme, there is a radical differ-

> ence between a corporate transfer of assets and a shareholder transfer of shares, <u>even if the effect in business and financial terms is essentially the same</u>. In general, immediate corporate tax can be averted and corporate basis and other attributes can be made to carryover by arranging a sale of stock rather than assets. In a nonreorganization acquisition, on the other hand, nothing carries over, and there will be some kind of final tax reckoning on the seller's side of the transaction. (emphasis added)/90/
>
> One effect of this welter of rules is to offer a considerable choice among different kinds of tax treatment of acquisition transactions. But effectuation of the choice often depends on tailoring transactions to comply with or avoid intricate definitional criteria to reach the right niche in the classificatory maze. This is often a matter of procedural inconvenience and sometimes a matter of substantial hazard because of uncertainties or unanticipated wrinkles in the controlling provisions./91/

4. Taxes should be imposed only when a recognition event occurs. One of the most fundamental tax policy problems for acquisitive transactions is that there are often no externally-based reasons to recognize gains or losses at particular moments./92/ Much of the controversy and debate about whether to retain or repeal the corporate level nonrecognition rules which codified the <u>General Utilities</u> doctrine revolved around what constitutes realization and, in turn, recognition, of gain at the corporate level when appreciated assets are sold or transferred in acquisitive transactions and complete liquidations./93/

By repealing the 1954 Code provisions based on the <u>General Utilities</u> doctrine without clearly articulating all of the tax policy reasons Congress did not resolve these critical issues in the TRA of 1986./94/ Only a few commentators believe the repeal of the General Utilities doctrine was incorrect as a matter of tax policy./95/ The TRA of 1986 did clarify the interaction of the revised complete liquidation provisions and the tax-free reorganization provisions/96/ but did not simultaneously enact the acquisition proposals. The separation of the General Utilities doctrine and the acquisition proposals will play an important role in determining whether the proposals will ultimately be enacted by Congress./97/

Three fundamental tax policy problems in reforming the tax law for acquisitive transactions are (1) the existence of different realization criteria for corporations and shareholders, (2) the resulting differences in inside basis of corporate assets (i.e., a corporation's basis in its assets) and outside basis in corporate stock (i.e., the shareholders' basis in their stock investment), and (3) lack of agreement on whether the strong or weak form of taxation should be used consistently throughout the Code.

Two important consequences of the differing realization criteria are that "potential and conditional tax liabilities at corporate and individual shareholder levels do not bear any strict or consistent relation to one another"/98/ and that inside and outside basis of a corporation frequently differ at any point in time. All commentators agree that tax provisions governing acquisitive transactions must provide specific rules stating how the potential and conditional liabilities of the target corporation at the time of an acquisitive transaction are to be handled. These tax provisions should take into account the competing goals (1) of horizontal equity and simplicity and (2) of stimulating certain activities and the potential for economic inefficiency if the tax law rule causes taxpayers to have to execute acquisition transactions in a commercially or legally inferior manner in order to achieve acceptable tax consequences.

Although corporate and shareholder income arises from the same underlying assets, production activity, and appreciation in value of corporate assets, the tax law contains quite different realization criteria for corporate and shareholder level realization of gain. In general, business activities that bring about a realization of gain at the corporate level, e.g., annual operating profits, do not, by themselves, cause a realization of gain at the shareholder level. Generally, shareholders of C corporations do not recognize gain until they receive a distribution of money or other assets from the corporation or sell or exchange their corporate stock in a taxable transaction./99/

Because of differences in realization criteria and other structural factors, the inside basis of corporate assets and the outside basis of corporate stock are rarely equal. The technical provisions of the tax law therefore become quite important from a tax planning perspective, particularly when the tax law elevates the legal form of the transaction over its economic substance as has historically been the case for Subchapter C of the 1986 Code./100/ Although the sale of all or substantially all of the assets of a corporation followed by a distribution of the sale proceeds to the shareholders and the sale of a controlling interest in the stock of a corporation are often stated to have similar economic consequences, these events typically have quite different tax consequences because of the differing inside and outside basis and because, under the 1986 Code, a sale of stock without a Section 338 election results in the imposition of a single shareholder level tax while a sale of corporate assets followed by a distribution of the sale proceeds results in the imposition of a corporate and a shareholder level tax./101/

A fundamental tax reform issue for acquisitive transactions is whether Congress, having repealed the General Utilities doctrine, should now act to minimize the role of the legal form in the taxation of acquisitive transactions, eliminate the system of transactional electivity, eliminate the categorical distinctions between economically similar types of acquisitive transactions, and enact more rational and economically efficient tax provisions governing the interrelated issues of the acquiring corporation's basis in the target's assets and whether the target corporation must recognize any gain or loss realized in acquisitive transactions. Many commentators believe Congress can and should resolve these issues by either (1) enacting the acquisition proposals, (2) mandating that the tax consequences of stock and asset acquisitions will be identical, or (3) amending Subchapter C to implement the consistent use of either the strong or weak form of taxation for acquisitive transactions.

The various 1954 Code provisions based on the General Utilities doctrine are very relevant examples of problems caused by differences in realization criteria. For many years, the tax law took the position that the imposition of a shareholder level tax upon gain realized upon receipt of liquidating distributions was enough of a tax burden (1) to justify nonrecognition of gain realized by a corporation upon making in-kind liquidating distributions to the shareholders or upon making liquidating sales of appreciated assets to third-party purchasers and (2) to justify allowing either the former shareholders or an acquiring corporation to take a stepped-up basis in the target's assets. By repealing General Utilities and allowing an acquiring corporation to obtain stepped-up basis in the target's assets only if the target corporation recognizes gain, Congress made major changes in these long-standing tax policies to address charges that the 1954 Code caused a significant lack of symmetry between the acquiring corporation's bases for assets acquired from the target and target corporation gain recognition and that taxpayers were systematically engaging in artificially structured transactions designed to exploit the nonrecognition of gain at the target corporation level./102/ Many commentators believe that although the repeal of General Utilities has resolved the lack of symmetry, it has not made the law less economically inefficient by penalizing taxable asset acquisitions as compared to carryover basis acquisition of corporate stock.

The "elective carryover basis asset acquisition regime" envisioned by the acquisition proposals/103/ allows the corporations involved in a QA to explicitly elect how the related issues of acquiring corporation basis for the target's assets and whether the target corporation will recognize gain (if its assets are appreciated) or loss (if its assets are depreciated) will be handled. The 1986 Code continues to force the parties to manipulate the legal form of the transaction and other matters of corporate procedure to achieve the desired results for these critical issues with the attendant possibility of economic inefficiency./104/

If, in a QA, the acquiring corporation makes a cost basis election, the acquiring corporation will take a cost (fair market value) basis for the target assets and the target corporation will recognize a gain or loss based on the difference between the fair market value and the inside basis of its assets. The acquiring corporation will thus receive a step-up (or step-down) in basis for the target's assets equal to the gain (or loss) recognized by the target corporation. When the shareholders of the target corporation receive consideration from the acquiring corporation, they will immediately recognize gain or loss realized to the extent the consideration is other than qualifying consideration.

If, in a QA, the acquiring corporation makes a carryover basis election, the acquiring corporation will take a carryover basis for the target assets and the target corporation will recognize no gain or loss. In a carryover basis QA, the inside basis of the target's asset (and other tax attributes of the target) will carryover to the acquiring corporation. When the shareholders of the target corporation receive consideration from the acquiring corporation, they will immediately recognize gain or loss realized to the extent the consideration is other than qualifying consideration.

Congress could enact the so-called "mandatory Section 338 approach" under which the sale of a share of corporation's stock is treated as a sale of a proportionate share of the underlying corporate assets. Although this approach is much harsher to taxpayers than the 1986 Code and violates some long-standing principles of corporate-shareholder taxation,/105/ the mandatory Section 338 approach would conform the tax treatment of stock and asset acquisitions and minimize the role of legal form and other matters of corporate procedure in determining the tax consequences of acquisitive transactions.

Other commentators suggest that Congress could simplify and rationalize the tax law for acquisitive transactions by having Subchapter C adopt and consistently utilize either the strong or weak form of taxation for acquisitive transactions. Zolt notes these are two conflicting but defensive views about what events constitute "realization" and recognition of gain previously accrued by the target corporation in acquisitive transactions and that the adaption and consistent use of either the strong or weak form would do much to resolve many technical issues and problems for acquisitive transactions./106/

The "strong form" of taxation requires the recognition of any gain realized at the corporate level when appreciated property, in whatever form, leaves its present economic group. The strong form focuses on the location of the asset instead of its tax basis in the hands of the transferee. Advocates of the strong form of taxation do not agree that forcing the transferee corporation to take a carryover basis in the assets is a sufficient "penalty" to justify nonrecognition of gain by the transferor corporation./107/ The strong form of taxation holds that the taxable income of a corporation should encompass all gains accruing to the corporation including all appreciation in the value of corporate assets. This view treats the corporation as having a taxable capacity and takes the position that the most equitable way to tax corporations is to tax gain defined comprehensively even if the same gain is subsequently taxed at the shareholder level./108/ The strong view holds that it is not proper for the tax law to interrupt the taxation of operating profits of either the acquiring or target corporation. For example, if the acquiring corporation acquires the target corporation at a premium (i.e., the consideration paid for the target's assets exceeds the inside basis), allowing the acquiring corporation to take a stepped-up basis in the target assets without requiring the target corporation to recognize all gain realized, the taxation of all operating profits is interrupted and therefore should not be allowed. The strong view supports the repeal of General Utilities.

The "weak form" of taxation requires the recognition of gain realized at the corporate level only if appreciated assets leave one economic group and receive a stepped-up basis in the hands of the transferee. The weak form focuses on the tax bases of the assets in the hands of the transferee and does not impose a tax on the transferor corporation unless the assets receive a stepped-up basis. The weak form explicitly recognizes that although corporations do not literally pay taxes because they have no separate taxable capacity, corporations can typically continue in existence substantially undiminished by paying a tax. This view holds that a corporate tax is, if nothing else, a tax on operating profits. Under this view, ordinary business income, but not gain on financial transactions, should be subject to double taxation. The weak form supports the repeal of General Utilities because it is not proper to tax the target corporation on gains realized upon a transfer of its appreciated assets to the acquiring corporation if the operating profits earned from the target's assets and operations will be taxed to the acquiring corporation./109/

Acquisitive transactions

Faber has identified the following five tax policy premises of the current tax law for acquisitive transactions:

1. The sale of a corporation's assets is the proper occasion for recognizing income which has previously accrued, regardless of the nature of consideration received

by the selling corporation and without regard to what the selling corporation does with the consideration after receiving it./110/ This premise is a very important compromise which recognizes that in an ideal or pure tax system, the imposition of an annual comprehensive shareholder level tax on the increase in value of corporate assets (1) would avoid the difficult problems of defining what constitutes a "realization"/111/ of gain or loss at the corporate and the shareholder levels in acquisitive transactions, (2) do much to eliminate tax planning resulting from differences in inside and outside basis for corporations and their shareholders, (3) avoid the necessity for special recognition and basis provisions applicable to acquisitive transactions, and (4) avoid the continuing problems which are the result of different events constituting a realization of gain or loss at the corporation and shareholder levels./112/

The ALI states:

> The main issues in the tax treatment of corporate acquisitions arise from the requirement that income be realized before it is taxed. The appreciation in value and other events that go into the earning of taxable income typically occur over some extended period of time, but are not taxed until some suitable event of realization. At any point in time, therefore, taxpayers typically have income and gains of various kinds in various stages of progress short of realization. Such unrealized income and gains carry potential tax burdens with them, and the main issue arising out of acquisition transactions are what to do about these potential but previously unrealized tax burdens. Should an acquisition be treated as an occasion for recognizing previously unrealized income

> or gain at either the corporate or shareholder level, or both, and if not, what, if anything, should be done to preserve potential taxability after the transaction is completed?/113/

Although practical and administrative considerations have and probably will continue to prevent the imposition of a comprehensive annual shareholder level tax, the ALI observes that acquisitive transactions would need no special tax treatment:

> . . . if [shareholder level] taxable income were equated with increase in value all to be taken into account and taxed in the period in which it occurred without any requirement of realization. Under such a regime, income tax liabilities would be completely settled in each taxable period, each new period would begin with a clean slate, and there would be no such thing as potential, conditional tax liabilities left over from one period to another requiring special treatment with acquisitive transactions./114/

In discussing comprehensive tax reform efforts, McClure agrees that an annual comprehensive shareholder level tax regime would obviate the need for special tax provisions for acquisitive transactions:

> In order to be totally fair and neutral, taxation must apply as income accrues, rather than merely as it is realized. However, the U.S. tax system has historically been based almost entirely on realization; the use of depreciation allowances is a long-standing notable exception./115/

In discussing the fundamental tax policy problems for acquisitive transactions, the ALI states:

> Gain and losses typically occur over some period of time, but are not taxed or deducted until the occurrence of some suitable event of realization, or later. At any point in time, therefore, taxpayers, both corporate and individual, have income, gains and losses of various kinds in various stages of progress

short of reflection in taxable income. One set of issues in the income taxation of corporations and shareholders is what to do about such previously untaxed gains and undeducted losses in connection with corporate acquisition and disposition transactions./116/

The Acquisition Proposals are addressed to this set of issues. They undertake to deal with the variety of forms acquisitions may take and with previously untaxed gains and undeducted losses at both corporate and individual shareholder levels. Under what conditions must such gains and losses be recognized in connection with the acquisition transaction itself? If such gains and losses are not recognized, should basis and other tax attributes be carried over, and under what limitations, if any, as to losses? What is the proper relationship between these issues, and between them and the form of corporate procedure adopted to effect an acquisition?/117/

There are two general ways potential corporate tax liabilities of an acquired corporation may be provided for: (1) they may be assumed, in effect, in the acquisition transaction, by having basis of corporate assets carry over undisturbed; or (2) they may be settled up or compromised or forgiven in the acquisition transaction itself, in which case asset basis will be henceforth redetermined by reference to cost in the acquisition transaction./118/

Under [the 1954 Code] there are different ways of achieving each of these modes of treatment. Most generally, corporate asset basis carries over in any acquisition that qualifies as a [tax-free] reorganization, whatever form it takes. But corporate asset basis also carries over, on quite different conceptual grounds, in the case of a simple purchase of stock that does not come near to being a reorganization, if the purchased corporation is kept in existence. On the other hand, a new cost basis will result from a nonreorganization asset purchase./119/

2. Sales of corporate businesses involving the sale of all or substantially all of the assets or the sale of a controlling interest in the stock of a corporation should qualify for tax-free treatment at the corporate and share-

holder levels./120/ The principal tax policy justifications for not requiring immediate recognition of all gain realized at the corporate and shareholder levels in acquisitive transactions are economic efficiency, stimulation of specific activities, and widespread acceptance of the fundamental equity of, and necessity for, the tax-free reorganization concept (i.e., deferred recognition of gain at the corporate and shareholder and security holder levels implemented by special basis rules). The concept of economic efficiency asserts that tax laws should not unduly interfere with a taxpayer's decision to sell or exchange individual corporate assets, corporate businesses, or shares of corporate stock.

The Joint Committee on Taxation states that when evaluating the tax law for acquisitive transactions, Congress should recognize that the tax law "may contribute to economic inefficiency not only by encouraging inefficient mergers but by discouraging efficient asset combinations."/121/ The Joint Committee on Taxation also cautions Congress not to create excessive tax barriers for acquisitive transactions:

> Forcing recognition of gain in certain corporate acquisitions could result in a 'lock-in' effect: sale of corporate assets to superior management might be discouraged by the triggering of adverse tax results./122/

Both the 1954 and 1986 Code contain rather involved and formal means of distinguishing which acquisitive transactions are immediately taxable, which should be allowed tax-free treatment, and how the conditional and potential tax liabilities of the target corporation should be handled. The 1982 ALI Study states:

> [The 1954 Code] contains a very intricate scheme of classification of acquisition transactions, some of whose boundary lines raise continuing, difficult, definitional problems. Implicit in the existing scheme, however, is a simpler, more functional classification, according to whether the acquisition involves an interruption and fresh start in the computation of taxable income from the acquired business, or involves a carryover of basis and potential tax liabilities. The [acquisition] proposal[s] would make that classification explicit and primary, and would make the classification of particular transactions as cost-basis or carryover-basis acquisitions explicitly elective and as independent as possible of constraints based on corporate-procedural considerations./123/

3. Tax-free treatment should be allowed only if the target corporation or its shareholders have a continuity of interest in the target's former business evidenced by the ownership of stock of the acquiring corporation or its parent and only when the acquiring corporation continues the business of the target corporation.

4. Tax-free treatment should be allowed only when certain tests are satisfied at the target corporation level./124/

5. Changes in asset bases to the transferee corporation for the transferor's assets should be directly linked to the recognition of gain by the transferor corpora-

tion./125/ Lobenhofer argues that, having repealed the General Utilities doctrine and adopted the weak form of taxation, Congress should now determine what types of consistency requirements should be required for acquisitive transactions./126/

Acquisition proposals

The acquisition proposals assume the imposition of a separate corporate level income tax and continuation of the long-standing rule that shareholders will only recognize gain or dividend income when they receive money or other assets from the corporation or sell or exchange their corporate stock in taxable transactions. The acquisition proposals assume that certain types of acquisitive transactions (i.e., QAs) should be eligible for tax-free treatment at the target corporation and target shareholder and security holder levels./127/ The central theme of the acquisition proposals is to allow the conditional and potential tax liabilities of the target corporation which exist at the time a QA is executed and the related issue of whether the acquiring corporation takes a cost or carryover basis for the target's assets to be disposed of by explicit election rather than manipulation of the legal form of the transaction.

The acquisition proposals follow the weak form of taxation by requiring the target corporation to recognize gains realized (i.e., consideration received in excess of inside basis of its assets) only if the acquiring corporation takes a fair market value basis for the target's assets. The acquisition proposals eliminate the categorical distinctions between reorganizations and other economically similar acquisitive transactions which existed under the 1954 Code and which were continued in the 1986 Code. The acquisition proposals substitute an explicitly elective taxing regime at the target corporation level in which either the acquiring corporation, or the acquiring and acquired corporations acting together, can explicitly elect how the conditional and potential tax liabilities of the target corporation should be handled in QAs./128/

The acquisition proposals make the corporate and shareholder level tax consequences now available by manipulation of the legal form of an acquisitive transaction explicitly elective at the target corporation level and as independent of the legal form of the transaction as possible./129/ The target corporation and target shareholder and security level tax consequences of QAs are partially uncoupled./130/ Target shareholders who receive only qualifying consideration in a QA (e.g., stock of the acquiring corporation) will immediately recognize none of the gain realized regardless of how the corporate parties elect to treat the transaction and regardless of the tax consequences of the QA to the other shareholders of the target corporation.

The acquisition proposals eliminate each of the three judicially created doctrines--continuity of interest, continuity of business enterprise and the business purpose doctrine--as prerequisites for tax-free treatment./131/ The ALI notes that although the courts may have been justified in creating these doctrines to protect the integrity of the early tax-free reorganization statues which did not specify the type of consideration which could be used by the acquiring corporation and whether the acquiring corporation must continue the business(es) of the target corporation, these doctrines should no longer serve as prerequisites for tax-free (i.e., QA) treatment. The inability of taxpayers, the Internal Revenue Service, and the courts to determine the boundaries of these judicial doctrines coupled with the conclusion that the use of these doctrines to distinguish "sales" and "reorganizations" often make tax consequences of acquisitive transactions depend much too heavily on relatively minor differences in corporate form or procedure caused the ALI to recommended their outright repeal./132/

The ALI states the continuity of interest doctrine represents an articulation of some underlying presupposition about what transactions should and should not be granted tax-free treatment./133/ Another reason for eliminating the continuity of interest doctrine is that the acquisition proposals attempt to separate the corporate and shareholder level tax consequences of a QA as well as the tax consequences of each shareholder of the target corporation to the greatest extent possible. Requiring a continuity of interest doctrine would frustrate both of these objectives.

As discussed in Chapter III of this Study, the boundaries of the continuity of business enterprise doctrine have never been clarified and the current continuity of business enterprise regulations have been criticized by the vast majority of commentators as unrealistic and easily manipulated. The shareholders of the target corporation often have little control over what the acquiring corporation does with the assets or businesses of the target corporation after an acquisition. The ALI believes that it is unreasonable to make the tax consequences for target shareholders dependent on events which are beyond their control. Thus the acquiring corporation does not have to continue the business of the target to be eligible for QA treatment at either the target corporation or target shareholder and security holder level./134/

The ALI concluded that the business purpose doctrine has proven to be less important in acquisitive transactions than in divisive transactions such as spin-offs and other tax-free divisions under Section 355. After considering the ill-defined boundaries for the business purpose doctrine and the general inability to distinguish the tax and nontax corporate and shareholders purposes in acquisitive transactions, the ALI concluded that there was no persuasive reason to require some type of business purpose doctrine as a prerequisite for shareholders and security holders of the target corporation to obtain tax-free treatment in a QA./135/ Commentators have concluded that the acquisition proposals would tilt the balance of Subchapter C toward further double taxation as the cost of obtaining symmetry and simplicity for acquisitive transactions. The ALI proposals advocated the repeal of the General Utilities doctrine as the key to rationalizing the federal income tax treatment of acquisitive transactions along more coherent and functional lines than the categorical distinctions contained in both the 1954 and 1986 Codes.

The acquisition proposals allow the tax-free results provided by the present operative provisions for tax-free reorganizations for acquisitive transactions structured and executed as QAs. The proposals expand the ability of the corporate parties to the transaction to elect carryover basis treatment for the target's assets or stock in the hands of the acquiring corporation and to expand the availability of deferred recognition of gain realized to the shareholders and security holders of the target corporation./136/ The ALI notes that although the tax-free reorganization definitions are "an unduly complex amalgam of varied and often conflicting statutory and extrastatutory requirements," the operative provisions for tax-free acquisitive reorganizations "provide in a relatively coherent way for nonrecognition of gain or loss and a concomitant continuation or carryover of basis for both corporate and individual parties to the transaction."/137/

Continuing Relationship of General Utilities and the Acquisition Proposals

One of the principal tax policy criticisms of the TRA of 1986 for acquisitive transactions is that Congress repealed the General Utilities doctrine without attempting to simplify and rationalize the tax-free acquisitive reorganization provisions, without enacting the acquisition proposals, and without considering all of the ramifications of the repeal of this long-standing part of Subchapter C. Zolt states that it is not clear whether Congress repealed the General Utilities doctrine to add greater consistency and rationality to the law, to increase tax revenues, to increase the costs of takeover transactions, to move toward a mandatory Section 338 taxing regime, or some combination of the above./138/

The tax literature contains detailed discussions of the General Utilities doctrine and arguments both for and against its repeal./139/ The major reasons for repealing General Utilities include:

1. Repeal was necessary to preserve the integrity of the two-tier corporate tax structure. The General Utilities doctrine disturbed this structure by allowing appreciated property to be sold or distributed by a target or liquidating corporation without either the recognition of gain at the corporate level or requiring the distributee to take a carryover basis in the distributed assets.

2. The General Utilities doctrine encouraged purely tax-motivated transfers of assets and corporate takeovers due to the combination of the ability to achieve a stepped-up basis at a low tax cost and the generous depreciation and other tax deductions resulting from a stepped-up basis in the hands of the distributee.

3. Even though the economic consequences were often identical, General Utilities encouraged corporations to make liquidating rather than nonliquidating distributions.

4. Repeal of the General Utilities doctrine would reduce complexity and lead to greater certainty and symmetry in the federal income tax system./140/

The major arguments for not repealing General Utilities include:

1. The General Utilities doctrine is needed to provide at least partial integration of the individual and corporate tax systems.

2. Repeal of General Utilities would have a disproportionate effect on small businesses./141/

3. Repeal of General Utilities without making changes in the tax-free reorganization and other acquisitive provisions will add complexity and uncertainty to the tax system./142/

4. Repeal of General Utilities without the concurrent enactment of the acquisition proposals will make the subsequently enactment of the proposals very difficult, if not impossible.

The 1986 Code provides no mechanism whereby a target or liquidating corporation can explicitly choose between (1) immediate corporate level recognition of any gain realized in an acquisitive transaction coupled with a stepped-up basis for the distributed assets in the hands of the purchaser or the shareholders or (2) nonrecognition of any realized gain coupled with a carryover basis in the distributed assets in the hands of the distributee./143/ The 1986 Code thus continues the system of statutory and transactional electivity which existed under the 1954 Code./144/

Leduc agrees with most commentators that the repeal of General Utilities is central to the acquisition proposals, particularly the proposal allowing the corporate parties to a QA to explicitly elect either cost basis treatment in which the target corporation recognizes all gain realized, or carryover basis treatment in which the target corporation does not recognize gain. In commenting on the Preliminary Staff Proposals, Leduc noted that one of the most frequently stated benefits of repealing General Utilities is simplification and rationalization of the 1954 Code because the exceptions to the doctrine (i.e., those provisions requiring corporate level recognition upon a sale or distribution of appreciated assets), were applicable in more cases than the corporate level nonrecognition rule itself./145/ The repeal of General

Utilities results in the recognition of corporate level gain upon a sale or distribution of an appreciated asset and thus greatly reduces the benefits of liquidation-reincorporation transactions./146/

The ALI, the staff of the Senate Finance Committee, the Treasury Department, and the Joint Committee on Taxation/147/ took the position that the repeal of the General Utilities doctrine was absolutely essential in order to change the corporate level tax consequences of acquisitive transactions from a system of statutory and transactional electivity to one of explicit electivity. The conclusion that the General Utilities doctrine resulted in a number of asymmetric results and must therefore be repealed to make the elective corporate level taxing regime workable/148/ was continued and elaborated upon in both the preliminary and final proposals issued by the staff of the Committee on Finance. Concerns about the lack of symmetry, possible systematic abuse of the corporate level nonrecognition provisions of the 1954 Code, and erosion of the corporate tax base played a role in the ultimate repeal of the doctrine.

A few commentators, notably the AICPA, strongly disagreed with the proposition that repealing General Utilities would be a panacea for the complexity and elevation of legal form over economic substance characteristic of Subchapter C of the 1954 Code. The AICPA expressed its conclusion that repeal of General Utilities was unnecessary as a matter of tax policy and the costs of repealing the doctrine would fall primarily on smaller and closely-held corporations. The AICPA stated the repeal of General Utilities should not be the quid pro quo for liberalizing the taxation of acquisitive transactions. The AICPA argued that when Congress codified General Utilities in the 1954 Code, the issue of whether it would unduly encourage corporate takeovers was not considered. The AICPA stated that even in the "megamerger" world of the 1980's, no one has yet made a persuasive argument that either sound tax policy or demonstrated systematic abuse of the General Utilities doctrine required the abandonment of this long-standing part of the Code which helped to integrate the corporate and individual tax regimes./149/

Should Congress Conform the Tax Consequences of Stock and Asset Acquisitions?

A fundamental tax policy and tax reform issue for acquisitive transactions is whether Congress, having repealed General Utilities and eliminated the asymmetric tax results for actual and deemed asset acquisitions and having repealed the lower effective tax rates for long-term capital gains of both individual and corporate taxpayers will now take what many commentators believe to be the next logical step and conform the tax treatment of asset and stock acquisitions. This is a highly controversial and political issue because it involves some very fundamental tax policy issues in the taxation of corporate-shareholder transactions./150/

There is no question that the repeal of General Utilities exacerbated the differences in tax treatment of actual and deemed asset acquisitions and stock acquisitions. Because the present value of the immediate tax cost of an actual taxable acquisition of assets or a deemed taxable acquisition of assets under Section 338 will, in all but a few situations, exceed the present value of the future tax benefits from the stepped-up basis for the target's assets only available under the 1986 Code in taxable transactions, virtually all commentators conclude that if the tax law was the only consideration, acquisitive transactions would be carried out as carryover basis acquisitions rather than taxable acquisitions./151/

Some commentators feel Congress is unlikely to give serious concern to conforming the tax treatment of stock and asset acquisitions, because such action involves some of the most fundamental issues in the taxation of corporate-shareholder transactions and would necessarily involve making even more radical changes than would the enactment of the acquisition proposals, the issue is important because in the post-General Utilities world, the future of the acquisition proposals appears to have become a subset of this more general issue./152/ Expressly conditioned on the repeal of General Utilities, the Treasury Department stated its support for the principle that the corporate parties to an acquisitive transaction should be able to explicitly elect the target corporation tax treatment and the basis of the target's assets or stock in the hands of the acquiring corporation regardless of whether the legal form of the acquisition is a purchase of the target's asset or stock./153/

The Treasury's position suggests to some commentators that because General Utilities has been repealed, the stage is now set for conforming the tax treatment of stock and asset acquisitions. The majority of commentators, however, feel (1) because the most serious problems associated with acquisitive transactions under the 1954 Code involved the asymmetric structural aspects of the Code and (2) because neither Congress nor the Treasury Department is convinced that taxpayers have systematically abused the tax-free acquisitive reorganization provisions of either the 1954 or 1986 Codes, the repeal of General Utilities is likely to be the only major tax reform enacted by Congress for acquisitive transactions in the short-run./154/

Yin has summarized the fundamental tax policy issues in conforming the tax consequences of asset and stock acquisitions:

> Under the current law [1986 Code], the acquisition of one corporation by another corporation produces dra-

> matically different tax consequences, depending upon whether the transaction is effected as an acquisition of all of the stock of the target corporation or all of the target's assets. The stock acquisition generally results in only a single tax at the shareholder level, unless the parties elect otherwise. In contrast, the asset acquisition may result in both a tax at the shareholder and corporate levels, if the acquisition is followed by a liquidation of the target corporation. This in an intriguing pair of results, given the fact that, if the stock acquisition is followed by the tax-free subsidiary liquidation of the target corporation into the acquiring corporation, the parties are able to achieve indirectly the economic equivalent of a direct asset acquisition of the target without the 'double tax' result./155/

Aside from important differences in matters of corporate law (e.g., transferee liability for undisclosed and contingent liabilities of the target which typically results in an acquisition of target assets rather than target stock), matters of corporate policy and differing business objectives, the basic tax policy issue in this area is whether there is any overriding theoretical or tax policy justification for taxing corporate acquisitions of assets or stock of the target corporation differently at either the target corporation or shareholder levels. Yin notes that in codifying the <u>General Utilities</u> doctrine and enacting Section 334(b)(2)/156/in the 1954 Code, Congress skirted this key issue and did not state a defensible policy justification for taxing asset acquisitions more heavily than stock acquisitions./157/ Yin implies that Congress avoided resolving these issues by enacting the complete liquidation provisions of Sections 333, 336, and 337 and Section 334(b)(2), each of which mitigated the differences in tax treatment of stock and asset acquisitions and helped to integrate the corporate and individual tax regimes.

Because the nonrecognition provisions of the 1954 Code generally allowed the target corporation to avoid the recognition of gain on liquidating sales or in-kind distributions of appreciated assets, the codification of General Utilities had the perhaps intended effect of minimizing differences in the tax consequences of stock and asset acquisitions. Allowing acquisitions of stock to be treated as acquisitions of assets and allowing the target corporation to avoid recognition of all gain realized on its actual liquidation into its new parent (i.e., the acquiring corporation), the enactment of Section 334(b)(2) coupled with the codification of General Utilities also had the perhaps intended effect of minimizing differences in the tax consequences of stock and asset acquisitions.

Yin asserts there are no theoretically sound policy justifications for taxing corporate acquisitions of assets and stock in a different manner in the post-General Utilities world. Yin notes that if the Treasury Department's report on Subchapter C mandated by Section 634 of the TRA of 1986 does not recommend conforming the tax consequences of asset and stock acquisitions, that conclusion will be based on political, rather than sound theoretical and tax policy reasons./158/ Assuming as he does that there are no compelling tax policy reasons for maintaining the present law distinctions between acquisitions of assets and stock, Yin argues that the tax law for acquisitive transactions should be made neutral as to the legal form of the acquisition. According to Yin, the law should allow the acquiring corporation complete freedom to structure the acquisitive transactions as asset or stock acquisitions. There are two ways to achieve such neutrality: the mandatory Section 338 approach and the elective carryover basis asset acquisition approach of the acquisition proposals. Yin states that these two alternatives are:

> . . . simply opposite sides of the same coin. Each starts from the proposition that there is no theoretical basis for maintaining the disparate tax treatment of corporate stock and asset acquisitions. Each, accordingly, attempts to provide symmetry in those two approaches. They differ, however, in how they would achieve that symmetry./159/

Yin notes that great uncertainty surrounds the enactment of the elective taxing regime envisioned by the acquisition proposals. Despite extensive study and debate, Yin feels that no consensus has emerged as to either the wisdom of enacting the acquisition proposals or the specific statutory language./160/

Yin describes the mandatory Section 338 approach as follows:

> The mandatory section 338 election approach begins with the assumption that, in the acquisition of a business enterprise, an assets acquisition is the paradigm case, perhaps because the amount of gain or loss on the sale of a business is more properly measured at the corporate level than at the shareholder level, which may reflect factors extraneous to the economic status of the business. As noted, under post-1986 Act law, an asset acquisition generally results in a tax at the corporate level (with a change in asset basis) and, in addition, if there is a subsequent distribution of the proceeds, another tax at the shareholder level. Accordingly, if a stock acquisition of the same enterprise is to have the same tax consequences, the stock acquisition must trigger both the corporate- and shareholder-level taxes. In effect, this requires a mandatory section 338 election for the stock acquisition, which also achieves the change in asset basis./161/

Yin describes the elective carryover basis asset acquisition approach as follows:

> The elective carryover basis option for asset acquisitions starts from the proposition that the stock acquisition is the paradigm case. At the corporate level, the stock acquisition achieves exactly the same tax consequences (nonrecognition of gain to the seller, plus carryover basis of assets with, in general, survival of corporate attributes) as an acquisition that qualifies as a reorganization. The key difference, however, is that the stock acquisition is not hobbled by the various reorganization requirements, such as continuity of interest; a stock acquisition solely for cash achieves the nonrecognition result at the corporate level. Hence, the elective carryover basis approach simply removes the reorganization shackles from a qualifying asset acquisition and allows the parties to elect reorganization treatment at the corporate level (to both the buyer and seller) even though the reorganization requirements are not satisfied. This approach, of course, was recommended by the American Law Institute and the Senate Finance Committee Staff./162/

Yin notes that how one views these alternative approaches depends to a large degree on how one views the role and scope of the corporate tax and what one considers to be appropriate realization events at the corporate and shareholders levels in acquisitive transactions. Yin notes that the tax law has traditionally viewed a corporation and its shareholders as separate and distinct taxpayers. Accordingly, a sale of corporate stock by the shareholder has not been viewed as a realization event at the corporate level. A corporate sale of its assets for cash or other liquid assets has historically been viewed as a realization event at the corporate level but not at the shareholder level unless the sale proceeds are actually distributed to the shareholders.

Yin notes that the mandatary Section 338 approach deviates most significantly from the principle that a corporation is a separate and distinct taxable entity from its shareholders and that a sale of corporate stock by the shareholders does not constitute a realization event at the corporate level. The elective carryover basis acquisition approach deviates most significantly from the principle that a cash sale of assets is a realization event at the corporate level and should result in corporate level recognition of gain or loss. Yin also notes that if, as opponents to the repeal of General Utilities and proponents of integration typically argue, the corporate level tax should only be imposed on operating profits, and not on appreciation in assets held in corporate form, then the absence of a carryover basis election creates the unjustified acceleration of corporate level income tax liabilities./163/

Yin believes that because either approach would be a radical departure from current law, each presents difficult and novel questions which must be resolved. Because the elective carryover basis approach would liberalize current law, it would reduce federal tax revenues and be difficult to enact given the massive federal budget deficits. The mandatory Section 338 approach requires the recognition of gain at both the target corporation and the target shareholders' level and will produce even harsher tax results for acquisitive transactions than does the 1986 Code. The mandatory Section 338 would thus not be a politically popular recommendation.

Yin notes that implementing the Section 338 approach is commonly perceived as more complex than implementing an elective carryover approach. However, Yin believes that enacting either approach would present a host of complex implementation issues./164/ Yin describes the factors which are most likely to persuade Congress to act or not to act on conforming the tax treatment of stock and asset acquisitions:

> First and foremost, I suppose, must be revenue, and on that score, the mandatory section 338 proposal will likely add revenue to the Treasury's coffers, a doubtful consequence of the carryover basis asset acquisition approach. Second, Congress may have some interest in the economic effects of the two options. On that question, there will undoubtedly be great un-

certainty with the likelihood of as many opinions as there are economists. If Congress continues to be in an antitakeover protectionist mood, it might tend to look more favorably on the mandatory section 338 option than the carryover basis approach. Finally, to the extent the theoretical validity of the proposals is a factor, there may be a draw. Each approach would seem to violate normative income tax principles; the question is whether that violation can be justified to accomplish a more significant policy goal./165/

Comprehensive Tax Reform Efforts

Most advocates of comprehensive tax reform agree with the following statements made by the Joint Economic Committee:

> In recent years, the Federal income tax has come under increasing attack from taxpayers, businessmen, and professional economists who believe its problems have grown so serious they can no longer be solved simply by tinkering with individual provisions in the tax code. Complete and comprehensive tax reform of the income tax, with all the problems cleaned up at the same time, has become the only reasonable way of improving the tax system.
>
> The increased interest in comprehensive tax reform has occurred because, by virtually every criterion, our tax system falls short. It fails to raise enough revenues to fund the government. It is riddled with unjustifiable deductions, exclusions, credits, and other preferences that erode the tax base while making the tax code incomprehensible to the vast majority of taxpayers. It distorts investment decisions, causing billions of dollars to be wasted in unproductive tax shelters while pressing capital needs go unmet. It violates all of the principles of tax fairness. It has become a source of economic instability and an impediment to intelligent personal and business planning.
>
> In addition to broad agreement that the income tax should be thoroughly revised, a consensus is developing on the right kind of tax reform. Virtually all of the major tax reform proposals would broaden the tax base by eliminating most of the existing de-

ductions, exclusions, and credits while at the same time reducing marginal tax rates. Most aim at revenue neutrality, though some taxpayers would pay more and some less. The differences fall into four main areas:

-- The choice of the tax base, with some proponents of reform advocating that the base be consumption rather than income;

-- The degree of rate progressivity, with proposals ranging from a straight flat tax to a simplified progressive tax;

-- The treatment of details, with proposals differing over the list of deductions to retain and eliminate, how to treat capital gains and losses, whether to retain indexation of the zero-bracket amount and the tax bracket, whether to permit indexation of capital basis and interest rates, how to treat depreciation of capital, and whether to change deductions into credits; and

-- Taxation of corporate income, with some reform advocates suggesting that the corporate income tax be eliminated by integrating it with the personal income tax./166/

The principal changes in the Code proposed by virtually all advocates of comprehensive tax reform, including Treasury I and Treasury II and tax legislation proposals introduced by various Congressmen,/167/ include:

1. expansion of the tax base by repealing a variety of deductions, exclusions and credits allowed by the 1954 Code;

2. reduction of marginal tax rates for all taxpayers;/168/ and

3. reduction in the degree of progressiveness in the tax rate schedules applicable to various taxpayers./169/

Although expansion of the tax base and lowering marginal tax rates for all taxpayers is now the common theme of tax reform efforts in many major industrialized nations,/170/ the tax literature suggests that comprehensive tax reform has not yet been enacted in the United States./171/ Some commentators assert that lasting tax reform may never be achieved due to massive federal budget deficits and other institutional factors (e.g., lack of a constituency for reducing entitlement programs such as Social Security and federal government bailouts of the thrift industry) which will cause Congress to increase marginal tax rates, particularly the top marginal tax rates applicable to individual taxpayers./172/ One Congressman argues that the "but-for" philosophy which pervades tax reform efforts (i.e., Congress should enact tax reform but for the proposed changes which may harm some specific individual or group) limits the possibility that Congress will enact lasting comprehensive tax reform./173/

Difficulties In Enacting Comprehensive Tax Reform

There are many difficulties in enacting comprehensive tax reform proposals in the United States. The political environment in which major tax legislation is considered and enacted in the United States is commonly acknowledged to limit the ability of Congress to eliminate "tax loopholes" and make the tax laws less economically inefficient./174/ McClure observes that genuine tax reform is very difficult to achieve:

> Even under ideal circumstances it is difficult for the general interest--represented by a tax system that is more equitable, less distortionary, and simpler--to triumph over the special interests who defend the multitude of particular provisions of the tax code that undermine fairness, neutrality and simplicity./175/
>
> The process of legislating (or even proposing) tax reform exhibits considerable resistance to change. Those who benefit from preferential treatment under current law fight hard to protect their privileges by wrapping them under whatever arguments and protective devices they can muster. Industries that would never have come into existence in the absence of preferential tax treatment send lobbyists to plead their cases. Provisions that make little sense, and which may not have even had strong advocates before enactment, become sanctified and are protected by the special interest groups that have spawned./176/

Congressmen are often reluctant to become involved with revenue-neutral simplification efforts/177/ because they typically encounter intense lobbying efforts/178/. Tax simplification and reform is very difficult to achieve, often has a desperately small constituency, and frequently can only be enacted in small packages./179/ In addition, some group always wants Congress to postpone making decisions on specific issues until "comprehensive tax reform" is accomplished./180/ Congress frequently does not devote its scarce time and legislative resources to tax simplification projects. Leduc states:

> In general, pure simplification projects, particularly in areas as complex as Subchapter C, have simply not been allocated scarce legislative resources by the Congress, in the absence of clear political or policy justification for such allocation./181/

Roderick DeArment, Chief Counsel to the Senate Finance Committee during the process of formulating the Subchapter C Revision Act of 1985, has made a number of comments which are relevant to the political process of tax reform and simplification and the possibility that the acquisition proposals will ultimately be enacted into the law./182/ DeArment observes that the repeal of the 1954 Code sections based on General Utilities is the main item of controversy in the Act's attempt to simplify and rationalize the taxation of acquisitive transactions./183/ DeArment asserts that the Subchapter C project is similar to the tax simplification efforts for both installment sales and Subchapter S corporations./184/ DeArment notes that there is almost zero political advantage for a member of Congress, and particularly the chairman of a tax writing committee, to become involved in tax simplification efforts./185/

Congress often enacts "tax reform" or "tax simplification" measures without fully considering all the resultant effects and consequences. Some "tax reforms" are not based on generally accepted tax policy criteria. As the TRA of 1986 demonstrates, the result is often incomplete tax reform, unintended economic consequences, and unintended changes in the balance between the corporate and individual tax systems./186/ In commenting on the TRA of 1986 and the Revenue Act of 1987, Zolt states that Congress should have, but clearly did not, evaluate the major changes enacted from an integrated or systems perspective. Zolt asserts that the Code has never before been so biased against operating a profit-seeking business as a C corporation./187/ Although many of the changes had strong political support (e.g., the repeal of the General Utilities doctrine), Congress enacted major changes in the federal income tax system in the TRA of 1986 without considering all of the consequences and quite possibly made the 1986 Code more economically inefficient than the 1954 Code./188/ Zolt believes that Congress' refusal to explicitly integrate the corporate and individual tax systems will cause taxpayers to seek a number of "self-help" integration measures which may force Congress to enact remedial legislation in the future./189/

Is A Solution Possible?

In discussing corporate-shareholder tax law generally and the acquisition proposals specifically, Leduc asserts that the "answer" to tax policy issues may either be intellectual (substantive) or political. Due to the complexity and interrelated nature of many Subchapter C issues, it may not be possible to find a commonly accepted intellectual solution. Another possibility is that intellectual solutions may be developed which would provide substantial simplification if adopted, but the solution cannot be enacted due to political considerations./190/ The ALI Studies, many individual commentators, and the Act assume there are "correct" solutions to the general and specific problems discussed in this Study./191/ In commenting on the future of the acquisition proposals, Leduc states:

> There are right answers in corporate tax reform. The failure of Congress to enact them in 1984 by no means establishes that the answers proposed by the [1982] ALI [Study] are wrong; quite the contrary, there is a surprising consensus to a wide range of the ALI's proposals. . . . At the same time, 1984 has confirmed the historic difficulty in enacting structural, simplifying reform./192/

In testifying on the final acquisition proposals, the AICPA accepted them as an intellectual solution. The AICPA, however, concluded that, as a whole, the acquisition proposals were incorrect as a matter of tax policy. The AICPA stated that, ultimately, the choice to be made about the acquisition proposals:

> comes down to the retention of the exiting law or the adoption of the Act's revisions tied to the repeal of <u>General Utilities</u>. In this case, we would prefer the retention of existing rules rather than suffer the dual detriment of the reversal of <u>General Utilities</u> and the disruption and additional complexity created by the Act./193/

Leduc notes that the critics of the acquisition proposals generally make three basic arguments to support the proposition that enactment of the proposals would not simplify Subchapter C:

1. Simplification is not possible. These critics argue that the enactment of the Installment Sales Revision

Act of 1980 and the Subchapter C Revision Act of 1982 did not achieve simplification./194/

2. The principal Subchapter C tax policy problem is not simplification but making the law more certain and predictable. These critics argue that (1) the enactment of the acquisition proposals will not create more certainty, (2) the short-run complexity caused by enacting the proposals will outweigh any possible long-run simplification, and (3) repeal of General Utilities is too high a price to pay for achieving simplification./195/

3. Concerns about the Government being whipsawed by corporations and shareholders who take mutually inconsistent positions on the tax consequences of a single transaction is an interesting academic theory but not a pressing practical problem. In the vast majority of situations, taxpayers are bound by the legal form of their transaction while the courts are much more likely to allow the Internal Revenue Service to use substance over form arguments to protect the revenue./196/

Major Goals of Comprehensive Tax Reform Efforts

The major goals of comprehensive tax reform efforts are to make the tax law more equitable, economic efficient, and simple and to stimulate those specific activities which Congress has determined are economically or socially desirable with as little economic distortion as possible./197/ These four goals are often used to evaluate new tax laws/198/ and proposed changes in existing laws./199/ These goals are ideals which often cannot be fully achieved in practice because they assume pre-tax conditions not present in the real world and because the individual objectives are often in conflict./200/ Miller, for example, states:

> . . . the individual objectives may themselves be in conflict. In other words, the pursuit of equity may interfere with neutrality, or achieving equity may be possible only with less simplicity. In practice, then, trade offs between the objectives may be required. Evaluating taxes against the generally accepted objectives of a good tax system is still a useful exercise, however, as policy makers and other citizens decide what trade offs are acceptable./201/

In testifying on the Preliminary Staff Proposals, Robert Jacobs noted the theoretical nature of the goal of economic efficiency:

> To be effective, the corporate tax law must be simple, certain and fair. Indeed, simplicity and certainty foster fairness. If we can achieve simplicity and certainty, substantial fairness will be automatically injected into the system. . . . But once the neutrality assumption is accepted and its principles become the theme of the remedial legislation, neither simplicity nor certainty should be sacrificed by blindly following the neutrality notion wherever it may lead. We should keep in mind that the neutrality principle, however well formulated, is nothing more than a convenient fiction./202/

Virtually all commentators agree that the four major goals of equity, economic efficiency, simplicity, and stimulation of economic activities should be used to evaluate changes in a taxing system./203/ McClure states:

"three primary objectives are commonly attributed to tax reform: fairness/equity, economic neutrality, and simplification."/204/ Although there is some debate as to whether these traditional tax policy criteria can appropriately be used to evaluate a tax system,/205/ virtually all commentators agree--at least in principle--that taxation should be fair, economically neutral and simple. Thus a major goal of comprehensive tax reform efforts is to design a tax system that implements these objectives while recognizing the inevitable trade-offs between them./206/

In commenting on comprehensive tax reform efforts, the Joint Committee on Taxation states:

> Several criteria are commonly used when evaluating tax proposals, including equity, efficiency, and simplicity. Individuals often agree that the revenue which is raised by the tax system should be collected in a manner which is as fair as possible, which produces as little unintended distortion in the economy as possible, and which is as simple to administer and understand as possible. In addition, certain provisions of the tax system have been enacted to encourage specific activities which Congress has felt should be promoted. The questions of equity, efficiency, simplicity, and the encouragement of specific activities are central to the discussion of whether the present tax system should be changed by enacting one of the comprehensive tax proposals currently being discussed./207/

Because there is near universal acceptance of these four general objectives of comprehensive tax reform efforts,/208/ this Study used them as the general criteria by which the acquisition proposals were evaluated.

Equity

It is very difficult to argue against the proposition that taxation should be carried out in an equitable manner or that improving the equity of a tax system should be a major goal of comprehensive tax reform efforts. Miller states that equity requires the burden of taxation be distributed fairly among taxpayers./209/ Most discussions of equity address the subissues of horizontal equity and vertical equity. The concept of horizontal equity underlies the proposition that taxpayers having similar ability to pay taxes, based on some concept of "income," should pay approximately equal absolute amounts of tax./210/ For acquisitive transactions, the concept of horizontal equity requires that economically similar transactions should be taxed in the same manner regardless of the legal form of the transaction or other matters of corporate procedure./211/

The concept of vertical equity underlies the uses of progressive taxation systems in the United States and elsewhere. Vertical equity suggests that taxpayers having the ability to pay more taxes should do so and that taxpayers should pay a relatively higher absolute amount of taxes as their incomes increase./212/ Although questions have often been raised about the practice of using taxable income as the measure of a taxpayer's ability to pay taxes, the Subchapter C Revision Act will not alter the federal income taxation of corporations and shareholders in this respect. Questions have also been raised about the difficult and admittedly subjective judgments involved in determining the degree of progressiveness of the federal income rate structure for corporate and individual taxpayers. Because the Act neither abandons the use of taxable income as the primary measure of ability to pay tax nor challenges the appropriateness of the progressive income tax systems applicable to corporations and their shareholders, this Study accepted these concepts in defining the major goal of equity.

Economic Efficiency

The major goal of economic efficiency can be defined as follows: taxes should interfere as little as possible with the incentives to engage in specific types of economic activity, except to the extent that Congress intends such effects./213/ The tax literature supports the assertion that any tax which satisfies accepted horizontal and vertical equity criteria almost invariably creates some interference with economic incentives./214/ McClure states:

> Taxation will be economically neutral only if two or more alternatives facing a given decision maker are subject to the same effective marginal tax rate."/215/

The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in the absence of taxes./216/ Most economists assume that resources are efficiently allocated by a competitive market system in existence before the imposition of a tax or major changes are made in the tax laws./217/

Achieving economic neutrality and avoiding economic inefficiencies are major concerns for the taxation of acquisitive transactions. As discussed in Chapters III and IV of this Study, the 1986 Code rewards carryover basis acquisitions and penalizes taxable acquisitions while the 1954 Code rewarded taxable acquisitions and penalized carryover basis acquisitions despite the fact that many of these acquisitive transaction are substantially identical from an economic perspective./218/ The 1986 Code continues to base the tax consequences of acquisitive transactions largely on legal form rather than economic substance and continues the categorical distinctions between "reorganization" and other types of acquisitive transactions. The possibility that the tax law forces taxpayers to structure acquisitive transactions in a commercially or legally inferior manner/219/ is evidence that the tax law is economically inefficient.

McClure asserts that economic life becomes more complex if taxation is not neutral./220/ McClure states that a tax is economically neutral if it does not affect economic decisions, except by reducing real income or wealth. McClure notes that neutrality only involves substitution effects (i.e., the allocation of resources induced by changes in relative prices). McClure observes that a neutral tax system will not necessarily result in an optimal allocation of resources because it will not necessarily minimize loss of welfare resulting from taxation./221/ The tax-free acquisitive reorganization provisions have several characteristics common to tax expenditure provisions. Tax expenditure provisions have been defined as:

> any deduction, exclusion, credit, preferential tax rate or tax deferral that departs from what some consider the 'normal' treatment one would expect in an income tax system that had no special incentives. Any particular provision is called an expenditure because, it is argued, the special tax treatment of the item substitutes for a federal outlay that could achieve the same result./222/

Congress does not systematically evaluate why various tax expenditure provisions are enacted or are retained. Simon questions how Congress can improve the economic efficiency of the income tax system without having a means by which to evaluate in a coordinated manner both direct government outlays and related tax expenditures./223/ Simon states:

> It is well recognized that defining the normative tax baseline, and hence 'tax expenditures' is not wholly a technical matter, and that political philosophy underlies many decisions as to classification. Scholars, who have struggled mightily to develop more rigorous analyses, have found the definitional issue to be complicated by the fact that not all types of

tax provisions are classified as tax expenditures for the same reason.

For example, the determination that the Code sections codifying what is generally called the General Utilities doctrine created a tax expenditure was made at the time the Deficit Reduction Act of 1984 was being proposed. At that time many Congress members had grown concerned about what they viewed as an alarming trend toward more and more corporate takeovers. Repealing the General Utilities doctrine would clearly add to the tax cost of many such takeovers. Thus, the determination to create a new tax expenditure relating to the retention in the Code of the sections codifying that doctrine was motivated in part by a desire to pass legislation aimed at reducing the number of takeovers. While many believe that determination could have been justified solely on the basis that the General Utilities doctrine as enacted in the 1954 Code deviated from the normative corporate income tax, a desire to achieve certain social and economic goals by eliminating it played a part in the classification./224/

The Joint Committee on Taxation has concluded that there is "little conclusive evidence" that federal income tax provisions have tended to increase the volume of merger activity./225/ In absence of conclusive evidence that, on balance, mergers and acquisitions harm the economy, and while admitting that the economy would be better off without certain tax-motivated mergers, many commentators believe the goal of economic efficiency requires federal tax policy to be as neutral as possible with respect to mergers and acquisitions./226/ The principal argument made for neutral tax laws (i.e., those which neither encourage nor discourage acquisitive transactions and those which base tax consequences on economic substance rather than legal form) is that management of the acquiring corporation will be more likely to make merger and acquisition decisions, including whether to engage in such transactions, the selection of specific target corporations, and the legal form used to effect an acquisition based on economic realities instead of real or perceived tax benefits. Many commentators believe that a more neutral tax law is likely to increase productivity by promoting the efficient flow of economic resources in the economy./227/

The tax literature supports the assertion that some economic inefficiency (i.e., interference with the incentives to engage in various types of economic activity which would exist in a world without taxes) is inherent in virtually all taxes which are acceptable based on horizontal and vertical equity criteria./228/ Thus, a major goal of tax policy and comprehensive tax reform efforts is to reduce economic inefficiency to as low a level as possible. This Study accepted this definition of economic efficiency and the related proposition that a major goal of comprehensive tax reform efforts is to reduce economic inefficiencies to the extent possible recognizing equity, simplicity, and other objectives.

<u>Simplicity</u>

Another major goal of comprehensive tax reform is to make the tax law as simple as possible. A simple tax requires fewer taxpayer resources to understand and attempt to comply with the technical provisions of the law than a complex law. A simple tax law will result in lower administrative costs than a complex tax law./229/ Another major advantage of a simpler tax law is the perception of horizontal equity by taxpayer. The Joint Committee on Taxation has stated:

> A second reason for a general preference for a simple tax system is that under a complicated system, similarly situated taxpayers may have different tax liabilities because they are not equal in their ability to understand the rules or pay for professional tax advice. The fact that investing valuable time and resources in tax planning may yield significant tax savings may undermine the perception that the tax system is horizontally equitable, among both those investors who do make such investments and those who do not. Taxpayers may suspect that others are paying less tax not because they have a lower ability to pay, but rather because they have better access to knowledge about the details of the system. If these feelings are widespread, they may contribute to a feeling that the system is not fair./230/

Because one of the most frequent criticisms of the present tax-free acquisitive reorganization provisions (and Subchapter C generally) is that they are needlessly complex, evaluation of proposed changes must determine if their enactment would make the tax law simpler. Roberts asserts that tax advisers are primarily concerned that the tax law is predictable and certain and that predictability and certainty are available at a reasonable cost./231/ Several commentators believe that tax laws based on the economic substance of a transaction, rather than its legal form, are more likely to be simple and understandable./232/ There is a vast literature on the subject of "tax simplification" in the United States. The literature indicates that taxpayers and their advisers have been concerned about the level of complexity of the federal income tax laws since at least 1918./233/ The simplification literature suggests there is a very high probability that tax simplification (however defined) in the United States will never be achieved./234/

McDaniel states that concerns about simplicity of the tax law derive fundamentally from the tax statute itself./235/ McDaniel, however, does not feel a more readable statute will, in and of itself, lead to simplification:

> The objective of tax legislative drafting is not to produce a statute that is easily understood, instead, it is to produce a statute which, if understood, cannot be misunderstood. In short, clarity and freedom from ambiguity for those who have the technical skills to understand the statute are far more important than readability./236/

The tax literature demonstrates that there are often conflicts between the major goals of simplicity, economic efficiency, and equity. A goal of tax policy is therefore balancing the often competing general objectives of equity, economic efficiency and simplicity./237/ This Study accepted these statements in evaluating the acquisition proposals.

Encouragement of Specific Economic Activities

The current federal income tax law applicable to tax-free reorganizations is a primary example of tax laws enacted by Congress principally to encourage (or at least not to discourage) and stimulate particular economic activities by corporate businesses and their owners rather than to promote the general objectives of equity, economic efficiency, or simplicity./238/ The tax literature suggests that when Congress decides to use the federal income tax law to encourage specific activities, the following two issues should be, but frequently are not, carefully considered and evaluated:

1. Is using the tax system more or less desirable than other means of stimulating the specific activity?

2. In using the tax system to stimulate specific activities, to what extent does such use conflict with the other general objectives of equity, economic efficiency and simplicity?/239/

The Joint Committee on Taxation has stated:

> At the same time, providing the subsidy through the tax system rather than some other mechanism may tend to interfere with the equity of the tax system. These subsidies result in a system in which tax liability is not made equal for taxpayers with equal ability to pay, and they change the relationship of tax liabilities for taxpayers with different levels of ability to pay. Further, such subsidies make the system more complicated, and may raise questions of efficiency. Although the provision of these subsidies through another administrative mechanism would involve similar issues of equity, efficiency, and simplicity, taxpayers' perceptions of the workings of the entire tax system may be affected when they are administered through a tax mechanism./240/

Because they allow a deferred recognition of gains realized by the corporate and noncorporate parties to an acquisitive transaction structured as a "tax-free reorganization" and are based on the principle that the tax law should not unduly interfere with necessary business readjustments or rearrangements, the tax-free reorganization provisions have some characteristics in common with tax expenditure provisions. In commenting on the relationship between comprehensive tax reform efforts and various tax expenditure provisions, the Joint Committee on Taxation states:

> . . . a thorough review of the income tax would have to confront the variety of special provisions that have been added to the law over the years to provide incentives for particular kinds of activities and to provide relief to particular kinds of taxpayers.
>
> . . . there are several important considerations. Tax expenditures have the advantage that they can be plugged into an administrative mechanism through which the government already communicates with a large number of its citizens. Tax expenditures do not generally require separate or detailed application forms, and they are received relatively quickly. On the other hand, most tax expenditures make the tax system more complex for the taxpayer and also reduce the extent to which the public perceives the system to be equitable.
>
> Tax expenditures may also cause administrative problems for the agency administering the tax system, which may be required to deal with policy issues outside its normal area of expertise. Tax expenditures have also been criticized for being, in effect, entitlement programs and not subject to the controls which the budget process imposes on new entitlement authority. It has been argued that, as a practical matter, some tax expenditures would not have been adopted, or would have been adopted in a much more limited form, if provided as budget outlays.

> Analysis of tax expenditures generally involves two issues. First, whether the nontax policy goal accomplished by the tax expenditure is worth the lost revenue and whatever other tax policy goals are being sacrificed must be decided. This is likely to be based on efficiency (benefit cost), distributional and administrative considerations. The second decision is whether these other approaches to achieve the nontax policy goal, such as spending or regulation, would be preferable./241/

This Study accepted the above statements about using the tax law to stimulate specific activities and the problems with tax expenditure provisions. As discussed, this Study used the four general objectives of the comprehensive tax reform movement in evaluating the acquisition proposals.

A Contrary Viewpoint

Not all commentators agree that equity, economic efficiency, simplicity, and stimulation of specific activities should be used to evaluate either the present tax law or proposed changes in the law. Shurtz, for example, believes that the use of such traditional tax policy criteria has impeded achievement of lasting tax reform in the United States. Shurtz believes that a reform of tax policy formulation resulting in a normative, coherent and articulable tax policy to guide the drafting of a workable and practical tax code is an absolutely essential prerequisite to successful and lasting tax reform. Shurtz states present tax policy is an ill-defined mixture of ad hoc tax, economic and social policies which are:

> . . . inarticulate and theoretically incoherent, and thus, in effect, an obstacle to effective tax reform. To develop a tax policy useful in the development of a tax system, the theoretical approach to taxation must be abandoned and a pragmatic approach must be adopted.
>
> . . . It should therefore be clear that there will never be successful tax reform, tax reform which results in an acceptable and essentially completed tax code, one unneedful of and resistant to continual further reforms, until there is a tax policy reform resulting in a normative tax policy./242/

Shurtz observes that, to be useful, tax policy must be redefined to the point where it can guide decision making on an operational level:

> On that [operational] level the tax system is not some monolithic manifestation of broad principles. Rather, it is a multitude of individual provisions that in the aggregate determine how comprehensive or burdensome the income tax will be. This is the greatest failure of the theoretical approach and where lies the greatest need for a pragmatic approach./243/

Shurtz argues that a normative tax policy requires the abandonment of the traditional theoretical-intellectual approach to taxation and the adoption of a more pragmatic approach. According to Shurtz, a pragmatic approach would have as its guiding principle the efficient collection of revenue and the use of objective measures to determine if revenue-raising and other goals are being satisfied./244/ Shurtz believes that using the tax system to shape the economy and promote beneficial social and economic purposes will inevitably operate to limit the capacity of the tax system to raise revenue./245/

Shurtz believes traditional tax policy criteria (i.e., the four general objectives discussed above) are not normative because they are primarily conceptual or intellectual in nature. Shurtz asserts that these traditional tax policy criteria have not proven to be useful in developing a workable tax code because they are theoretically inconsistent./246/ Shurtz states:

> Because traditional tax policy criteria represent social and economic as well as revenue raising objectives, conflicts among the policy criteria are frequent and unavoidable. Traditional tax policy is predicated upon shifting theoretical tenets. Thus, regardless of how facially persuasive a particular analysis might be, no analysis could ever be compelling because it is unclear whether the tenets of tax policy which served as its foundation were not subordinate to conflicting tenets which compelled a different result./247/

Traditional tax policy is theoretical because one of its major tenets is that a multitude of general and specific purposes should be served by the tax system./248/ Most commentators agree that the general purposes can be grouped as follows: revenue-raising; administerability; stability; horizontal and vertical equity; neutrality; and maintaining the political order. There are a number of serious conflicts between the general purposes./249/ Shurtz notes that although traditional tax policy theorists characterize the positive aspects of general and specific criteria of tax policy:

> in every case their possible aspects are indirectly derived from the negative effects that flow directly from taxation. Perhaps the most obvious case is the

> criterion of neutrality. Almost all tax theorists would admit that taxation, by its very nature, will slow economic growth, yet the goal of neutrality is simply to affect the economy as little as possible./250/

The traditional tax policy concepts of horizontal and vertical equity are, in Shurtz's view, illustrative of the inherent limitations of using traditional tax policy concepts to formulate a workable tax code. Shurtz notes that even under today's "modern" federal income tax law there is no agreement as to what constitutes "income" from either an intellectual or a workable administrative perspective. Shurtz feels the commonly accepted Haig-Simons definition of income/251/ has contributed nothing to the design, implementation and administration of any real tax system./252/ Shurtz also notes that although the use of progressive tax rates can be justified because it raises more taxes from an given tax base than do other tax rates, the theoretical-intellectual notion of vertical equity has been of little assistance in developing a workable tax system./253/

Shurtz concludes that because any general or specific reform measures will inevitably have conflicting consequences, it is impossible to determine the proper reforms using traditional tax policy criteria:

> Ordinarily, tenets of policy are revised or deleted when they conflict with superior tenets, which, in turn, requires the determination of a hierarchical order to be given to the criteria. This would seem to be applicable to the criteria of federal income

> tax policy because there are frequent and unavoidable conflicts among them. But traditional tax policy makes no pretense of establishing a normative hierarchical order. It does not attempt to reconcile or eliminate conflicting criteria, nor does it give any quantifiable weight to the criteria. The traditional tax policy literature indicates that each of the criteria should be included in tax policy. Consequently, these traditional theorists are constrained by the theoretical approach to accept each of the conflicting criteria as valid criteria of tax policy. Once tax theorists have reduced the tax system to its theoretical tenets, there is no basis on which to distinguish among them. In theory, each criterion is valid./254/

Subgoals of Comprehensive Tax Reform Efforts

The comprehensive tax reform process is a very fragile process which rests on a temporal consensus that the existing federal income tax law is being systematically abused or is in conflict with other major federal government policies./255/ Congress does not frequently devote its scare time and legislative resources to such technically complex and arcane areas as Subchapter C and the taxation of acquisitive transactions. The fact that the staff of the Senate Finance Committee spent several years studying these issues, issuing a preliminary report, holding hearings, and issuing a final report (which included suggested statutory language) suggests the importance attached to determining sound tax policies for acquisitive transactions by the Senate Finance Committee.

In testimony on the Preliminary Staff Proposals, Robert Jacobs struck a sense of urgency regarding the need to reform the taxation of acquisitive transactions:

> I urge that we not let this opportunity to fix the corporate tax law escape. One of your staffers observed that this subchapter C project has been more 'labor intensive' than any one anticipated. The thousands of hours invested by your staff and its volunteers in this project will deter all but the most dedicated from trying to soon revive it, if it fails enactment by this 98th Congress. Corporate tax law is too complex and the concerned constituencies too small to muster often the requisite legislative effort. The program has been set in motion, the corporate tax provisions are ripe for reform. I urge you to act on these proposals and bring simplicity, certainty and fairness to our corporate tax law./256/

As discussed in Chapter II of this Study, the tax literature does not contain a generally accepted set of tax policy criteria (hereafter subgoals of the comprehensive tax reform effort) by which proposals for changes in the taxation of acquisitive transactions should be evaluated. In response to the issuance of the final acquisition proposals, Thompson has formulated his recommendations to simplify and rationalize the tax-free reorganization provisions. Thompson's proposals would make changes in the tax-free acquisitive reorganization provisions but would continue the categorical distinctions between reorganizations and nonreorganization acquisitive transactions./257/ The chart on the following page lists the major goals of the comprehensive tax reform effort for acquisitive transactions broadly defined and the related subgoals. The subgoals were identified and grouped with the most appropriate major goal by the researcher based on (1) a thorough review of the tax and other relevant literature, (2) a thorough review of the historical development of the acquisition proposals, and (3) the researcher's judgment.

Subgoals

1.0 Equity

1.1 The fundamental principles underlying the current tax law should be reexamined.
1.2 The "whipsaw" possibilities of the current law should be addressed.
1.3 The application of the common law judicial doctrines of continuity of interest, continuity of business enterprise, and business purpose should be clarified.

2.0 Economic Efficiency

2.1 The frequent elevation of form over substance in the current law should be reduced or eliminated.
2.2 The tax law should be more neutral among combinations, purchases, and divestitures of business enterprises.
2.3 The tax law should more clearly distinguish the tax consequences of complete liquidations and tax-free acquisitive transactions.

3.0 Simplicity

3.1 The level of complexity of the current tax law should be reduced.
3.2 The mandatory nature of the federal income tax treatment of tax-free acquisitive reorganizations at both corporate and shareholder/security holder level should be eliminated.
3.3 Problems with "overlap" issues should be addressed.
3.4 The application of the step transaction doctrine should be clarified.

4.0 Stimulation of Specific Activities

4.1 Corporations and shareholders should be able to restructure continuing corporate investments on a tax-free (tax-deferred) basis.
4.2 The basis rules applicable to both the corporations and the shareholders/security holders should continue to ensure the eventual recognition of gains realized, but not immediately recognized, by both the corporations and the shareholder/security holders involved in a tax-free acquisitive reorganization.
4.3 The tax law should allow much more flexibility in determining the federal income tax consequences of tax-free acquisitive reorganizations for the corporate and noncorporate parties involved.

Comprehensive Tax Reform Efforts for Acquisitive Transactions

Most advocates of comprehensive tax reform for acquisitive transactions agree an examination and reassessment of the underlying rationale and economic and behavioral effects of deviations from a pure income tax system should be the first step toward making improvements in the federal income tax system. The tax-free reorganization provisions and other deviations from a pure tax system have been justified on the need to provide tax incentives for certain types of taxpayer behavior or, alternatively, not to provide significant tax disincentives for certain types of taxpayer behavior and on the wherewithal-to-pay principle at the target corporation shareholder and security holder levels./258/ The inefficiency and problems which occur when taxpayers who are participants in acquisitive transactions must operate in either the statutorily elective or the transactionally elective areas of Subchapter C are discussed in Chapter III of this Study.

One of the most frequently stated criticisms of present law is that because only well-financed taxpayers can afford to hire the sophisticated tax counsel necessary to operate successfully in these complex areas of the tax law, the law violates the basic notion of horizontal equity. Stated differently, because not all taxpayers have equal access to sophisticated tax advisers, the principle of horizontal equity is frequently violated. Some commentators believe enactment of the acquisition proposals will make the law more horizontally equitable because the benefits of tax-free treatment will be more easily and readily available to all taxpayers who engage in economically similar transactions./259/

As discussed in Chapter III of this Study, the federal tax law contains two types of tax incentives for acquisitive transactions: general rules regarding the measurement of income from capital and specific provisions regarding the taxation of acquisitive transactions. Those who believe the Code provides too many tax incentives for acquisitive transactions have identified two approaches to reducing these incentives: comprehensive tax reform along the lines suggested above/260/ and legislation designed to discourage specific transactions such as limiting the deductibility of interest expense on acquisition indebtedness/261/ and the attractiveness of leveraged buyout transactions./262/

Many commentators agree that a tax system which does not accurately measure income from capital will inevitably create incentives for tax-motivated mergers and acquisitions. A few commentators believe complete integration of the corporate and individual tax systems is necessary to substantially reduce or eliminate tax-motivated mergers and acquisitions./263/ Most commentators believe enactment of a much more comprehensive tax base coupled with the imposition of lower marginal tax rates "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."/264/

The Joint Committee on Taxation asserts that a full range of proposals for reforming the tax law governing acquisitive transactions should identify and address the fundamental causes of tax-motivated or tax-supported mergers including the double tax regime, the deductibility of interest but not dividend payments, and the transferability of net operating losses and other tax attributes./265/ Two primary reasons for the lack of a consensus on whether the current tax laws provide too many, too few, or are neutral toward acquisitive transactions is the lack of a commonly accepted standard against which to compare the behavior of firms/266/ and the inability to empirically measure firm behavior against the standards./267/

The current federal income tax system in the United States applicable to acquisitive transactions deviates from a pure income tax system in many respects. Most commentators on the federal income tax laws agree with the conclusion that "any new tax system that disregards basic tax principles would likely be as bad as the current one."/268/ Equity, simplicity, economic efficiency and using the taxing system to promote specific activities and the inherent trade-offs between these general criteria are cited in virtually every Congressional hearing and report on the issue of comprehensive tax reform of the federal income tax system generally/269/, on the issue of comprehensive tax reform of the federal income taxation of corporate-shareholder transactions, and in reports and hearings on the acquisition proposals.

Many commentators agree with the Treasury I's critique of the corporate income tax provisions under the 1954 Code and the accompanying need for comprehensive tax reform:

> The taxation of capital and business income in the United States is deeply flawed. It lacks internal consistency, and it is ill-suited to periods when inflation rates have varied and have been unpredictable. It contains subsidies to particular forms of investment that distort choices in the uses of the nation's scarce resources. It provides opportunities for tax shelters that allow wealthy individuals to pay little tax, undermine confidence in the tax system, and further distort economic choices. Equity investment in the corporate sector is placed at a particular disadvantage by the double taxation of dividends. Resulting high marginal tax rates discourage saving, investment, invention, and innovation. Moreover, high marginal rates encourage efforts to obtain additional special tax benefits which, if successful, further erode the tax base and necessitate higher rates in a never ending cycle.
>
> The Treasury Department's tax reforms would rationalize the taxation of income from business and capital. An overriding objective is to subject real economic

> income from all sources to the same tax treatment. Implementation of the reforms proposed by the Treasury Department would cause improved reallocations of economic resources. The lower tax rates made possible by base-broadening and the more realistic rules for the measurement of income and calculation of tax liabilities will increase the attractiveness of industries that suffer under the weight of the current unfair and distortionary tax regime. Both established industries and new "high tech" industries will benefit from tax reform. But the ultimate beneficiaries will be the American public. No longer will the nation's scarce economic resources--its land, its labor, its capital, and its inventive genius--be allocated by the tax system, instead of by market forces. The result will be more productive investment, greater opportunities for employment, more useful output, and faster economic growth./270/

Proposals for comprehensive tax reform of the taxation of corporate-shareholder transactions and acquisitive transactions, can be grouped into two broad categories: those aimed at improving the current system and those that would substitute a new system, such as some sort of consumption tax./271/ Because they would expand tax-free treatment now available to target corporation and its shareholders and security holders under the operative rules for tax-free reorganizations while eliminating many of the statutory and judicial prerequisites to tax-free treatment contained in the 1986 Code, the acquisition proposals clearly attempt to improve the current system./272/

Common objectives of proposals for "comprehensively" reforming the taxation of corporate-shareholder transactions are to address (1) the erosion of the tax base through tax evasion/273/, (2) the overtaxation of capital income and the resulting dysfunctional consequences,/274/ and (3) the unnecessary complexity of the tax system./275/ Treasury I, Treasury II, and the Subchapter C Revision Act are based on the belief that assessing tax on the taxpayer's "income" continues to be appropriate. According to this view, the deterioration in the performance of the present tax system is caused primarily by its departure from the framework of a pure income tax./276/

The changes in the tax law governing corporate-shareholder transactions enacted during the Reagan Administration have emphasized economic growth and using the tax law to create incentives for saving and investment for both corporate and individual taxpayers./277/ The Accelerated Cost Recovery System (ACRS), the safe-harbor leasing provisions, and the liberalization of the rules for deductibility of contributions to Individual Retirement Accounts (IRAs) enacted in the Economic Recovery Tax Act of 1981 (ERTA) are primary examples. Critics of the Reagan Administration's economic and tax philosophies point out that many of the tax incentives provided in ERTA to corporations were too generous and that they were responsible for substantially reducing the yield from the corporate tax./278/ Critics also note the safe-harbor leasing provisions were eliminated in the Tax Equity and Fiscal Responsibility Act of 1982/279/ after costing the government approximately $37 billion dollars in lost tax revenue in about one year./280/ Many aspects of ACRS as enacted in ERTA were eliminated in subsequent tax legislation, particularly the TRA of 1986, once Congress recognized that the liberal ACRS provisions were largely responsible for the formation of unproductive real estate tax shelter arrangements./281/ Critics also note that the very large reductions in marginal tax rates for both corporate and individual taxpayers enacted in ERTA did fundamentally alter saving and investment patterns in the United States as predicted by the Reagan Administration./282/

The corporate tax law changes made during the Reagan Administration have been highly technical and very complex. Many commentators believe the imposition of the corporate alternative minimum tax in the TRA of 1986, along with its financial accounting and corporate financial reporting implications, may be the most complex and controversial change enacted during the Reagan Administration for C corporations./283/ The replacement of Section 334(b)(2) by the statutory elective provisions of Section 338 in TEFRA was justified on the grounds that making the corporate tax consequences of certain nonreorganization acquisitive transactions statutorily elective, rather than forcing the corporate parties to manipulate the legal form of the transaction in order to achieve the desired tax results, would make the tax law more economically efficient and simpler. The majority of commentators agree that the experience to date with the complex and highly technical provisions of Section 338, and the related regulations, does little to support the proposition that the tax law for acquisitive transactions can be radically improved by making the corporate level tax consequences of acquisitive transactions explicitly elective./284/

Certain changes made in the federal income taxation of corporations and their shareholders in the TRA of 1986 and the Revenue Act of 1987/285/, particularly the nominal reduction in corporate tax rates,/286/ and the elimination of the lower tax rates on long-term capital gains/287/ may reduce the severity of certain perceived problems in the taxation of tax-free acquisitive transactions under the 1954 and 1986 Codes./288/ To the extent that acquisitive transactions are in fact primarily motivated by, and structured to take advantage of, actual or perceived tax benefits (e.g., the nonrecognition of gain by target corporation allowed by the 1954 Code provisions based on the General Utilities doctrine), instead of by economic and strategic considerations, many of the changes made in the TRA of 1986 should be welcomed by advocates of comprehensive tax reform for corporate-shareholders transactions./289/

Many commentators believe that the outright repeal or radical changes in the various provisions based on the _General Utilities_ doctrine, particularly the complete liquidation provisions along with other changes in the federal income tax consequences of taxable acquisitions such as the enactment of Section 1060/290/, will provide significantly increased incentives for the acquiring corporation to structure transactions as carryover basis transactions, rather than as taxable acquisitions or as acquisitions of stock treated as asset acquisitions under Section 338. Many commentators believe that the repeal of the 1954 Code provisions based on the _General Utilities_ doctrine represents a significant first step toward comprehensive tax reform for corporations and their shareholders in the acquisitions area and may allow the eventual enactment of the acquisition proposals./291/ Other commentators feel, however, that by repealing the _General Utilities_ doctrine without making the other changes in the corporate tax provisions recommended in the Subchapter C Revision Act, Congress has not achieved comprehensive tax reform for corporate-shareholder transactions and, as discussed in Chapter V of this Study, may have substantially reduced the chances that the acquisition proposals will ever be enacted by Congress.

Visions of Subchapter C

Leduc and Gordon state that there are two views or visions on the need for comprehensive tax reform of the taxation of corporate-shareholder transactions: the orthodox view that Subchapter C does not need major structural reform and the radical view that it does. The radical view holds that many recent developments and innovations (e.g., acquisition and divisive techniques to avoid the repeal of General Utilities)/292/ will compromise the integrity of the classical two-tier corporate income tax system to the point where the payment of corporate income tax may become largely a voluntary act. Congress has not consistently followed either vision in recently enacted major tax legislation./293/ In commenting on the Tax Reform Act of 1986, Leduc and Gordon state:

> The [enacted] provisions that were added had two sources: a desire to eliminate abuses and a need to raise revenue. The debate between the classical view and the fundamental reformers was waged, generally, in the trenches of the reluctant revenue estimators: if it could be shown that a provision could produce revenue or close a loophole it was included regardless of its theoretical approach. The effect of the competing views was not paralysis, only the loss of theoretical consistency; ultimately the rhetoric of abuse and the dollars and cents of the revenue analysis became dispositive./294/

Those who accept the radical view identify three fundamental areas in which transactional innovations threaten the integrity of the two tier tax system: the massive erosion of the corporate tax base;/295/ inability to identify the taxpayer;/296/ and the loss of the full shareholder level tax on distributions to shareholders./297/

The radical view suggests the most significant future tax policy developments in Subchapter C lie in the area of corporate distributions and divisive transactions and not in the area of acquisitive transactions. The radical view suggests while the nonrecognition provisions such as the tax-free incorporation and tax-free reorganization provisions may need some "technical corrections," they do not have substantial problems, are not playing a significant role in the erosion of the tax base, and, accordingly, are not in need of the comprehensive tax reforms suggested by the acquisition proposals./298/

Treasury I and II

The term "comprehensive tax reform" is used in this Study in the same manner as used by the various Congressional tax-writing committees: an attempt to move from the present taxing system toward a pure income tax system. In November 1984, the United States Treasury Department issued a three volume study with the formal title Tax Reform for Fairness, Simplicity, and Economic Growth (hereafter Treasury I). Treasury I was prepared by the Treasury Department at the request of President Reagan in his State of the Union address in January 1984 as an initial step in the comprehensive tax reform process. The issuance of Treasury I and tax reform proposals by various Congressmen illustrate the growing interest in the topic of comprehensive tax reform by Congress, businessmen and the general public.

In May 1985, the Reagan Administration issued its response to Treasury I which was entitled <u>The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity</u> (hereafter Treasury II)./299/ The changes proposed for corporations and shareholders in Treasury I and Treasury II were similar although Treasury II contained more departures from a pure tax system than Treasury I./300/ Neither Treasury I nor Treasury II contained detailed suggestions for reforms in the provisions governing acquisitive transactions.

The primary goal of Treasury I was to create a tax system that minimizes interference with free-market forces (i.e., is less economically inefficient). The overall objective of Treasury I was to attempt to approximate the ideal of a comprehensive annual income tax in order to minimize the distortive effects of taxation./301/ Treasury I proposed a more comprehensive definition of income and the elimination of certain preferential deductions and credits. The cornerstone of Treasury I was a broad based modified flat tax on individuals accompanied by a flat tax on corporate income at a 33 percent rate. Treasury I recommended that most exclusions, deductions, credits and tax-deferral provisions which are inconsistent with a decision-neutral tax system be eliminated or curtailed./302/ Charles McClure, a principal author of Treasury I, states:

> Treasury I was a far-reaching attempt to introduce a truly comprehensive income tax that would have provided fundamental tax reform. . . . Treasury I reflected a strategic decision that fundamental tax reform would be feasible only if virtually all forms of preferable treatment were eliminated simultaneously in order to achieve substantial and visible benefits of rate reductions, fairness, neutrality, and simplification./303/

Based on the difficulties experienced in attempting to enact comprehensive tax reform in the United States, Treasury I rejected the notion that tax reform can only be achieved incrementally and took an "up or down" approach./304/

Most commentators agree that the issuance of Treasury I in November 1984 clearly indicated that the Congress was ready to address the issue of comprehensive tax reform./305/ The principal changes proposed in Treasury I for corporations and their shareholders included:

1. imposition of a single corporate tax rate of 33 percent;
2. repeal of the special corporate alternative tax rate on long-term capital gains;
3. indexation of the cost or other basis of capital assets for inflation;/306/
4. repeal of the investment tax credit provisions;
5. indexation the cost or other basis of depreciable assets for inflation;
6. tax depreciation to approximate economic depreciation and not to be based on a set of arbitrarily short lives;

7. allow regular corporations to deduct 50 percent of dividends paid; and

8. repeal the corporate alternative minimum tax provisions./307/

The following statements from Treasury I are illustrative of the need for comprehensively reforming the 1954 Code:

1. In a real sense, the United States income tax has grown without any conscious design or overall planning since it was enacted in 1913./308/

2. Deviations from a comprehensive definition of income such as allowing exclusions, deductions, tax credits, and deferral of tax liability originated in a incomplete understanding of the concept of income or in outmoded ideas about the proper fiscal relationship between the Federal government and state and local governments./309/

3. Treasury I discussed how deviations from a comprehensive tax base cause the tax to be economically inefficient (i.e., to interfere with individual and corporate decision making)./310/

President Reagan's tax proposals were similar in many respects to those contained in Treasury I. The following representative statements from President Reagan's tax proposals illustrate this similarity, particularly the need to move toward a less economically inefficient tax system.

1. Equity investment in the corporate sector is dis-

couraged by the relatively high effective rate of taxation imposed on the return from such investment. A graduated rate structure for corporations would be maintained, in order not to increase the burden on small corporations./311/

2. The disparate tax treatment of debt and equity in the corporate sector distorts a variety of decisions concerning a corporation's capitalization as well as its policies with regard to investment or distribution of earnings. The double taxation of corporate earnings distributed to shareholders also increases the cost of capital for corporations and discourages capital-intensive means of production in the corporate sector. Similarly, double taxation discriminates against goods and services that are more readily produced or provided by the corporate sector as well as activities customarily engaged in by corporations./312/

3. Depreciation allowances should reflect the economic fact that, on average, the value of assets decline over time due to a variety of factors, including declining productivity, wear and tear and obsolescence. If depreciation allowances understate real economic depreciation of a particular asset, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. Similarly, if depreciation allowances exceed

real economic depreciation, unwarranted incentives are created for investment in depreciable property./313/

4. Investment distortions created by the ACRS system, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. Paradoxically, these distortions do not reflect stated government policy to favor particular assets or industries. As a result, tax policies operate as undeclared government industrial policies which largely escape public scrutiny and systematic review./314/

The principal changes proposed by President Reagan for corporations and their shareholders included:

1. imposition of progressive corporate tax rates with a maximum rate of 33 percent;
2. retention of special 28 percent tax rate on net long-term capital gains;
3. cost or other basis of capital assets would not be indexed for inflation; however, depreciable and depletable assets would be eligible for long-term capital gain treatment;
4. repeal the investment tax credit provisions;
5. indexation of the cost or other basis of depreciable assets for depreciation;
6. tax depreciation would be based on lives shorter than economic lives;
7. allow the corporation to deduct 10 percent of dividends paid; and

8. continue the basic features of the corporate minimum tax under the 1954 Code./315/

In commenting on Treasury II, Charles McClure has noted:

> The President's proposals would have been an improvement over current law [the 1954 Code]. But since the three primary components of tax shelters (acceleration of deductions, preferential treatment of capital gains, and full deduction of nominal interest expense) survived, it was necessary to include a minimum tax on corporations and individuals in the President's proposals. In short, the tax reform proposals officially sanctioned by President Reagan were only a dim shadow of those submitted to him by the Treasury Department six months earlier; compared to Treasury I they would be less equitable and less neutral, and would achieve less simplification.
>
> The transparency of the political compromises in the President's proposals, in such areas as fringe benefits and the tax treatment of oil and gas, made it clear that this was to be political business as usual, rather than a legitimate attempt to rationalize the U.S. tax system./316/

TRA of 1986 As Incomplete Tax Reform for Acquisitive Transactions

A number of basic tax policy issues affecting the taxation of all acquisitive transactions have not yet been adequately addressed. Because the repeal of General Utilities was to simplify and rationalize the Code and make the taxation of acquisitive transactions more economically efficient and symmetrical, it is ironic that the repeal has been criticized as causing more uncertainty and economic inefficiency in the federal income tax treatment of acquisitive transactions./317/ Zolt notes that the repeal of General Utilities focused on the primary, and most publicized, aspects of the complete liquidation provisions of the 1954 Code: the ability of the acquiring party to achieve a stepped-up basis in appreciated assets coupled with a permanent exemption from corporate tax on the appreciation at the target corporation level. The repeal of General Utilities, as reflected directly in Section 336 and indirectly in Section 338, sought to correct this lack of symmetry and "abuse" of the two-tier corporate tax system by requiring recognition of gain at the target or liquidating corporation level when assets receive a stepped-up basis./318/

Zolt and other commentators agree that in repealing the General Utilities doctrine, Congress did not come close to following all of the recommendations of the 1982 ALI Study or the collateral changes suggested in the Act. Specifically, the repeal of General Utilities was:

1. not coupled with the virtual elimination of the 1954 and 1986 Code's tax-free reorganization provisions;

2. not coupled with any permanent exceptions for certain types of assets or for "small business"; and

3. no relief was provided at the shareholder level for corporate level taxes paid in corporate liquidations and acquisitive transactions./319/

An emerging topic in the tax literature is that the repeal of General Utilities has not reduced, but may have increased, the tensions in the tax law between differing tax treatments for asset sales,/320/ sales of stock,/321/ acquisitions for which a Section 338 election is made/322/, and tax-free reorganizations./323/ In the opinion of many commentators, the repeal of General Utilities has done little to rationalize and simplify the federal income taxation of acquisitive transactions. The system of transactional electivity still exists, the categorical distinctions between economically similar types of acquisitive transactions still exist, and the tax law frequently elevates the legal form of transactions over their economic substance. The acquiring party can still effectively elect between recognizing gain at the target corporation level and achieving a stepped-up basis in the assets or deferring the recognition of gain and leaving the basis of the underlying assets unchanged by manipulating the legal form on the transaction./324/ The 1986 Code has done little to reconcile the treatment of various transactions which combine aspects of both stock and assets sales. Many of these transactions were designed to avoid the impact of the repeal of the General Utilities doctrine and have a common theme: appreciated assets are transferred out of an economic group following an acquisition but remain in corporate form and retain their historic bases./325/

Zolt asserts that the 1954 Code provided a rough equilibrium between the individual and corporate federal income tax systems and did much to unofficially integrate/326/ corporate and individual taxation. The ability of shareholders to defer taxation of corporate income until distributed, the favorable tax rate for long-term capital gains, and the corporate level nonrecognition provisions which codified the <u>General Utilities</u> doctrine roughly offset the double taxation of distributed corporate income./327/ Zolt states:

> Before the 1986 Act, the corporate tax system, while not perfectly balanced, was in rough equilibrium. . . . Although there were plenty of tax-induced distortions, enough compensating balances existed that, generally, tax considerations influenced but did not dictate taxpayer decisions on the form of investment, financing, and dividend policy. Although past tax law changes have affected the compensating balances in the tax system, nothing compares to the disequilibrating effects of the 1986 Act changes. Blinded by the desire to substantially reduce individual tax rates and to maintain revenue neutrality, Congress destroyed the compensating biases in the tax system. The 1987 Act further exacerbated the situation./328/

The TRA of 1986 made the following changes which, according to Zolt, did much to upset this rough equilibrium:

1. eliminated the lower tax rates for long-term capital gains of individual and corporate taxpayers;
2. repealed the <u>General Utilities</u> doctrine; and
3. inverted tax rates (e.g., the maximum marginal corporate tax rate exceeds the maximum marginal individual tax rate)./329/

Zolt states that strong theoretical/330/ and political arguments were made for each of these changes; they were, however, the principal items which mitigated the harshness of the double taxation of distributed corporate income under the 1954 Code. Zolt notes that the elimination of favorable tax treatment for long-term capital gains dramatically departs from prior tax law and that the repeal of <u>General Utilities</u> is very controversial./331/ Zolt argues that the repeal of <u>General Utilities</u> will:

1. increase the cost of operating a business as a C corporation;
2. encourage businesses to be operated as partnerships which are not subject to double taxation upon liquidation or termination;/332/
3. encourage corporations to distribute earnings as dividends; and
4. encourage corporations to substitute debt for equity in their corporate structures./333/

Zolt criticizes Congress for enacting these changes:

> . . . the taxation of corporations and their shareholders is in an unstable state. The condition results from changes in the 1986 and 1987 Acts. Congress enacted these changes without a full consideration of their effect on corporate taxation. The time is ripe for Congress to focus on the taxation of corporations and their shareholders and to reestablish some balance in the corporate tax system./334/

Many commentators believe that the 1954 Code provisions based on the <u>General Utilities</u> doctrine made economic sense and followed the tax policies of the entire European Economic Community and Canada. The principal reason is that <u>General Utilities</u> helped to integrate corporate and individual taxes and helped to reduce the tax burden on corporate capital. The acquisition proposals are not based on integrating the corporate and shareholder level taxes./335/

Several commentators opposed the repeal of the _General Utilities_ doctrine unless it was accompanied by some attempt at integrating the corporate and shareholder level taxes. Opponents of the repeal of _General Utilities_ often state that the prime concern of the corporate tax system should be economic efficiency rather than simplicity or an over-reactive concern with abuse and manipulation./336/ In commenting on the assertion that the _General Utilities_ doctrine should be repealed to maintain the integrity of the two-tier tax system, John Nolan stated:

> In fact, we have never had a truly integrated corporate tax system in which a tax is paid on income at the corporate level and a second tax is paid on corporate income by the shareholders. Over the seventy or more years that our corporate income tax system has developed, we have had a compromise system in which double tax has been imposed on ordinary earnings from regular corporations to the extent that they are distributed to the shareholders as dividends, but only a single tax has been imposed upon extraordinary events, such as a sale or distribution of assets pursuant to a corporate liquidation.
>
> In reality, we have to a large extent had only a single ordinary income tax on regular corporate earnings because of the ability to retain earnings. By reason of our provision for step-up in basis of assets at death, earnings taxed at ordinary rates at the corporate level have to a large extent been retained and have not been taxed again at the shareholder level. At most, they have been subjected to capital gains tax on the sale of stock at the shareholder level. A large percentage of corporations in the United States, both publicly-held and privately-held, retain and reinvest a large percentage of their annual earnings, partly as a result of the tax advan-

tages to the shareholders that flow from this policy./337/

Evaluation of the Acquisition Proposals

Tax Literature and Congressional Hearings

James Eustice was very supportive of the acquisition proposals:

> Adoption of an explicitly elective system governing the corporate-level tax consequences of 'qualified acquisitions' and adoption of a uniform definition for 'qualified acquisitions' creates a significantly superior regime to the transactional electivity and definitional chaos that exists in current law./338/

Eustice expressed concern that the acquisition proposals reflect a "seeming paranoia" that some taxpayers might abuse the tax system and that, as a result, the proposals are more complex than necessary to achieve their stated objectives. Eustice notes this paranoia has totally dominated major tax legislation enacted by Congress in the 1980s and is largely responsible for the "tortuous complexity" of Subchapter C of the 1954 Code./339/ The Tax Executives Institute expressed general support for the acquisition proposals because they would increase certainty and consistency of tax treatment at the corporate and shareholder levels and would allow taxpayers to structure transactions according to business realities rather than having to structure business realities to the tax consequences./340/

Several commentators noted that the repeal of the

General Utilities doctrine and enactment of the acquisition proposals would most likely lower the value of corporate assets and stock because few QAs would be coupled with a cost basis election. The AICPA opposed the elective tax regime because it is unfair to force all shareholders to shoulder the cost of those target shareholders who can arrange to receive only acquiring corporation stock or securities in a QA./341/ Some commentators characterized the acquisition proposals as yet another example of "make-work laws dreamed by theoreticians who are too divorced from tax practice."/342/ Posin notes that the acquisition proposals are very complex, particularly the elective tax regime at the target corporation level. In view of the major complexities caused by the mixture of the entity and aggregate concepts used in partnership taxation, Posin expresses concern (1) that the acquisition proposals use the partnership lexicon of inside and outside basis, (2) that future tax legislation will treat a corporation as an aggregation of assets rather than an entity, and, as a result, (3) the corporate tax law may become as complex and uncertain as partnership tax law./343/

Posin notes that once an acquisition jumps through a strict set of transactional hoops in order to achieve QA status, the proposals achieve their stated goal of making corporate level tax treatment explicitly elective. However, because corporations can structure transactions to avoid QA status, transactional electivity is still present and the proposals do not achieve their goal of creating a simple, explicitly elective tax system./344/ Another problem is that post-transaction actions or inactions can upset the corporate level tax consequences:

> The entire elective system can also be upended by taxpayer transactions subsequent to an election. For example, suppose the parties engage in a transaction in which the acquiring corporation acquires over seventy percent of the gross fair market value of the assets of the target and over ninety percent of the net assets of the target. This transaction would constitute a qualified acquisition. The parties do not elect a cost basis acquisition, and the transaction will therefore be treated as a carryover basis acquisition. Suppose, however, that the target corporation does not distribute all of its assets within the required twelve-month period following the acquisition. The transaction will then belatedly be deemed unqualified, and twelve months after the fact it will have to be restructured as taxable, with a cost basis to the acquiring corporation./345/

Posin also states:

> Moreover, there is an air on unreality about the provision for explicit election of cost basis treatment. Taxable cost basis treatment is always available under the new rules if the parties simply fail to have a qualified asset acquisition. . . . one may intentionally fail to meet those requirements. Thus, the parties who are clear that they want a cost basis, taxable acquisition--for example, for purposes of stepping-up the basis of the acquired assets for depreciation--may be advised, depending on the tax consequences to the shareholder, simply to structure their transaction so that it fails to become a qualified acquisition, rather than to create an qualified acquisition and run the risk that the election for cost basis treatment will be filed improperly, causing them to be stuck with carryover basis treatment. Thus few transactions would ever actually run the pattern of a qualified asset acquisition followed by a cost basis election./346/

Posin notes that one of the fundamental reasons for the ALI studies and the work of the staff of the Senate Finance Committee was to eliminate the sharply varying tax consequences of economically similar acquisitive transactions. Posin concludes that the acquisition proposals have not achieved this goal:

> The new proposals, however, would also allow the tax consequences of acquisitive transactions that are economically similar to vary sharply, at the option of the parties. The difference between the current and proposed regimes is that under the latter the option is de jure while under the former the option is de facto. Indeed . . . the proposed rules would still operate as a largely de facto regime./347/

In testifying on the final acquisition proposals, Auerbach noted that by removing the procedural impediments to mergers and acquisitions, the acquisition proposals may have the effect of making tax consequences even more important:

> . . . but if the provision for such [explicit corporate level] elections merely simplifies activities that are already being practiced, it seems like a good idea. In making it less difficult and legally costly to arrange different combinations of shareholder and corporate tax consequences, however, you would be increasing the total tax incentives for merger activity since firms could more easily choose the combination offering the greatest total tax advantage. This makes the proposals to change the corporate tax treatment of cost basis and carryover basis acquisitions even more important./348/

In commenting on the Preliminary Staff Proposals, Martin Ginsburg stated:

> If the world were made up of corporations, all of which operate one business each, own no extraneous

assets, and surely have no subsidiaries, these rules can work in a very efficient and sensible fashion.

The [proposals] seem to me to crumble a bit when we think about real companies. Real companies operate more than one business; they may have divisions, they may have subsidiaries, they may have a mixture. I think a great deal more work really needs to be done here. . . . Unless we end up with a product that reaches comprehensive and sensible results without regard to whether a corporation is operating through divisions or subsidiaries, or a combination, we have not done a very efficient or effective or worthwhile job./349/

Ginsburg and other commentators/350/ conclude that in spite of the complexity and technical detail of the final proposals, they need much more work to neutralize the tax treatment of corporations operating through divisions as compared to subsidiaries./351/ James Eustice expressed concern that the consistency rules contained in the Subchapter C Revision Act result in a state of affairs which is not readily defensible:

1. Wholesale and unfettered corporate level electivity of tax results is not present and consistency of cost or carry basis results is not as rigorous as under current law.

2. The accidental fact that assets end up in a corporate division, rather than in a controlled subsidiary, takes on considerable significance because the consistency rules apply to assets held in divisions but not in subsidiaries./352/

Eustice testified:

I, for one, would allow total electivity, without any consistency limitations, so long as assets are still in corporate solution, since the essence of the Staff's acquisition proposal is that basis step-ups must exact a corporate-level toll charge. In other words, if the parties want to step-up basis, then

> gain will be recognized and tax paid; if they don't, then no gain will be recognized at the [target] corporate level, but will be at the shareholder level if boot is involved. Carving out exceptions to this regime for 'related parties,' goodwill, inconsistent acquisitions of assets, etc. will surely lead us back into the mess we now occupy under section 338, all for little in the way of abuse prevention. The consistency rules were adopted in 1982 because of General Utilities; with the repeal of the latter, the need for these limitations no long exists./353/

Leduc joins other commentators in criticizing the "surprising" basis rules for the parent's basis in a controlled subsidiary, a situation which occurs if the acquiring corporation acquires all of the stock of the target but does not immediately liquidate it. The acquisition proposals contain a "mirror basis" rule under which the acquiring corporation's basis in the target stock will mirror the target corporation's inside basis in its assets. The mirror basis rules have been criticized as being extremely complex and potentially unfair, particularly for carryover basis QAs./354/ In the case of an acquisition of the stock of a subsidiary for which a cost basis election is made, the inside basis of the assets of the subsidiary will be increased to the amount paid by the acquiring corporation and the appropriate gain will be recognized by the transferee corporation. Under the mirror basis rule, the acquiring (parent) corporation will then take a basis in the target's stock equal to the new cost basis of its assets. Leduc characterizes this result as logical and appropriate. The complexity arises when the target (now subsidiary) corporation acquires the assets of another corporation and a cost basis election is made. Here, the parent will have to adjust its basis in the stock of the subsidiary because the bases of the subsidiary's assets has changed. Leduc states that in a real world chain of corporations, the operation of the mirror basis rules will be very complex./355/

Proposal One

> The Act repeals present Section 368 and creates new Section 364. Section 364 contains the statutory definition of a "qualified acquisition" which includes "qualified asset acquisitions" and "qualified stock acquisitions." Qualified acquisitions encompass each of the five types of tax-free acquisitive reorganizations defined in current law which were the subject of this Study and transactions described as Section 338 transactions in the 1986 Code./356/

Proposal One was well received by all who testified on the acquisition proposals. The AICPA, for example, expressed its long-standing support for standardization of the definitional structure for acquisitive transactions broadly defined and the elimination of the arbitrary statutory definitions for tax-free reorganizations contained in Section 368./357/ Aidinoff, a tax lawyer, testified that the elimination of the present tax-free reorganization definitions and the varying types and amounts of consideration allowed for tax-free treatment will make the tax law more economically efficient./358/ James Eustice stated that eliminating the alphabet soup of statutory definitions for various types of tax-free acquisitive reorganizations and their varying consideration requirements would, in and of itself, make the acquisition proposals worth enacting./359/

Other commentators praised the more functional definition of a QA because it provides more certainty and predictability in distinguishing a tax-free acquisition and a taxable sale and helps to eliminate the hypertechnical system of integrating the current collection of statutory definitions for tax-free acquisitive reorganizations with the broad and often uncertain scope of the judicial doctrines in determining if there is a taxable sale./360/

Proposal Two

> The Act eliminates the following three long-standing common law judicial doctrines which serve as prerequisites to tax-free acquisitive reorganization treatment under current law: continuity of interest; continuity of business enterprise; and business purpose.

A number of practitioners who testified noted that the continuity of interest doctrine is unnecessary in the elective taxing regime envisioned by Proposal Three and in the regime in which the shareholder level tax consequences of a QA depend solely on the type of consideration received envisioned by Proposal Four./361/ Leduc states that varying degrees of continuity of interest allowed under the 1954 (and 1986) Code generate undue complexity:

> That complexity takes the form not only of the uncertainty arising out of the judicial assault on the statutory requirements but also the form of asymmetrical results depending on the direction of the subsidiary merger./362/

Posin asserts that the elimination of these judicial doctrines and the explicit electivity of corporate level tax results will decrease the desirable "tax polarity" (i.e., opposition of interests) between the acquiring and the target corporations and will erode the corporate tax base by significantly increasing the number of acquisitive transactions eligible for tax-free treatment at the corporate and shareholder levels./363/ Posin is concerned that the elimination of the continuity of business enterprise doctrine and the rather complex consistency period rules proposed by the staff will lead to abuses:

> For example, corporations may engage in the selective advance purchase of appreciated assets to gain a basis step-up in those particular assets, followed by an acquisition in which they elect no taxability and carryover basis for the balance of the assets./364/

Several commentators feel that the judicial doctrines should be made uniform instead of being completely eliminated./365/ Thompson believes the final acquisition proposals are seriously flawed in several respects: they are extremely complex; they are subject to manipulation; and they will seriously erode the tax base by significantly expanding the number of acquisitive transaction that are eligible for tax-free treatment at the corporate and shareholder levels./366/ Thompson concludes that it would be ironic for a Congress that amended the like-kind exchange provisions of Section 1031 in the Tax Reform Act 1984 to make it clear that exchanges of partnership interests did not qualify for tax-free treatment would subsequently devitalize the like-kind exchange provisions by allowing an exchange of any type of stock in an acquiring corporation to be made on a tax-free basis by the shareholders of the target corporation without regard to the nature of other consideration paid by the acquiring corporation in making the acquisition./367/

Thompson states a number of reasons why the elimination of these long-standing judicial doctrines could lead to significant abuses:

> For example, by repealing the continuity-of-business enterprise and continuity-of-interest doctrines, the 1985 SFC [Senate Finance Committee] Proposals would allow tax-free treatment on the constructive liquidation of a corporation. This could happen where a target corporation sold all of its assets and thereafter held only cash. An acquiring corporation could then cause the target to merge into acquiror with the target shareholders receiving stock of the acquiring corporation in exchange for their target stock. The merger transaction would qualify as a QAA [qualified asset acquisition]; therefore, the shareholders of the target would receive nonrecognition treatment on receipt of the stock of the acquiring corporation. Obviously this transaction is a mere liquidation of the target and yet the target's shareholders receive nonrecognition treatment.
>
> The situation could be even worse. After the asset sale, the target could, for example, distribute cash to eighty percent or ninety percent of its share-

holders in redemption of their stock and then merge into the acquiring corporation with the remaining target shareholders receiving stock of the acquiring corporation. Because of the repeal of the Elkhorn Coal case and the consequent disregard of the distribution in determining whether the 90-70 [percentage] test [for qualified acquisition status] has been satisfied, the merger would qualify as a QAA and the remaining target shareholders would receive nonrecognition treatment. Here there is a liquidation to the extent of eighty to ninety percent of the target's shareholders, followed by the acquisition of the minority's share of the cash in a tax-free transaction.

From a tax policy standpoint there are compelling reasons (mainly prevention of erosion of the tax base through artificial, tax-motivated sham reorganizations) to treat a constructive taxable liquidation as an actual liquidation. Present law reaches this result through the use of the continuity-of-interest, continuity-of-business-enterprise, and business-purpose doctrines.

Another problem is the unlimited boot feature of the 1985 SFC Proposals. This provision is hard to justify in a tax system that has always provided, as a general rule, that taxpayers are subject to taxation on an exchange of property. The reorganization provisions, which provide an exception to the general taxation rule, were first added in the Revenue Act of 1918. In interpreting this and successor provisions, courts have uniformly held that a reorganization contemplates a continuing interest by the target's shareholders in the 'affairs' of the acquiring corporation through a stock ownership in the acquiring corporation. In enacting the 'solely for voting stock' requirement of section 368(a)(1)(B), (C), and section 368(a)(2)(E) reorganizations, Congress has codified this continuing interest requirement. Furthermore the regulations and case law make it clear that there must be some continuation of the target's business by the acquiring corporation.

This dual concept of continuing the target's business in the acquiring corporation is consistent with other provisions in the Code that provide nonrecognition treatment. For example, a continuation of an interest in assets transferred underlies nonrecognition treatment in a section 351 transaction. Similarly, a nontaxable like-kind exchange under section 1031 requires that property 'used' in a trade or business be swapped for like-kind property to be 'used' in a trade or business.

The requirements of (1) a continuing shareholder interest, (2) a continuity of business enterprise, and (3) a business purpose, may be viewed as the guardians of the tax base. Otherwise, taxpayers could structure transactions that in form are a mere reshuffling of corporate interests, but in reality are sales or liquidations of interests in the corporation. Indeed, the approach of the 1985 SFC Proposals (and the ALI Proposals) is to provide nonrecognition treatment to what are, in substance, sales transactions so long as only an individual shareholder receives stock (even marketable stock) of the acquiring corporation or an affiliate thereof./368/

James Eustice also expressed concerned that the final acquisition proposals do not completely abandon the continuity of interest doctrine:

The definition of 'qualified consideration' is tied to stock of a 'party to the acquisition,' and the proposal in section 366(d), generally delegates to regulations selection of those affiliates in the acquiring group who will be appropriate party 'guests.' I would have expected that here at last was the occasion to rid the Code once and for all of any lingering remanents of the Groman-Bashford doctrine and its uncertain radiations, which have probably done more than any single court decision to complicate and confuse Section 368. The Staff's Technical Explanation, however, invites the regulations to perpetuate a direct 80 percent chain linkage to the acquiring corporation in order to qualify as 'party stock'; if we are abolishing continuity of interest generally, let us do so all the way, and certainly here. I can think of no persuasive reason why stock of any member of an acquiring affiliated group should not constitute qualified consideration stock. . . . I would emphatically hope that the job of repealing Groman finally could be finished.

In this same vein, I am saddened to see that the Groman 'remoteness' concept continues to apply on the acquired corporate side of the transaction, as well,

> since only the target can be exchanged tax free under [proposed] section 354(a). The effect of this limitation is that tax-free acquisitions of subsidiaries of the target are only entitled to nonrecognition treatment at one level, i.e, tax-free treatment is tied solely to the acquired subsidiary's stock, which is the case under current law. This result seems to me to put an unnecessary premium on the happenstance of corporate structure. I would propose that stock received in the acquisition at least should be purged of any gain potential, which is the Staff's proposed general rule, but which rule does not apply in the instant case as noted subsequently. A partial cure is provided in [proposed] section 354(c), but this provision does not go far enough in my view since it only applies to cases where all of the parent's assets are acquired in the transaction, and furthermore only extends to one level in a chain of corporations. I would go all the way here and allow nonrecognition treatment at all levels where stock of the acquiring corporation is the sole consideration received./369/

In testimony on the Preliminary Staff Proposals, representatives of Deloitte Haskins and Sells expressed concern that the Preliminary Staff Proposals deviate too far from present reorganization law and would do much to abolish 50 years of tax history. The firm felt that instead of completely eliminating the continuity of interest doctrine, it should be strengthened as part of an effort to rationalize the present reorganization provisions./370/ The firm also expressed concern that the acquisition proposals are not sound from an economic standpoint:

> Moreover, in our view, as long as we have a dual taxation of corporate income, we will need rules to mitigate the harshness of that system. To do otherwise will discourage the formation of corporate capital, an essential element of our economy. Much of the staff proposals, primarily those involving the repeal of the <u>General Utilities</u> doctrine, would have the opposite effect. A truly neutral system of tax-

ation, one that would neither encourage nor discourage the corporate form of doing business, would not impose a double tax on the appreciation of assets while in corporate hands. Any revision to subchapter C of the Code should be undertaken in a deliberate manner, correcting abuses by direct address rather than evoking a new system of taxation with its resulting distortion and uncertainties upon corporate transactions./371/

Proposal Three

Under the Act, new Section 365 allows the corporations involved to explicitly elect the corporate level federal income tax consequences of a qualified acquisition. A cost basis or a carry over basis election can be made in connection with a qualified acquisition. These elections determine whether the target corporation will recognize the gain inherent in its assets, whether the acquiring corporation will take a cost or carryover basis for the target's assets, and how the conditional and potential tax liabilities of the target corporation at the time of the qualified acquisition will be handled.

In a cost basis acquisition, the acquiring corporation will take a cost basis in the assets acquired from the target corporation and the target corporation will recognize the gain inherent in each of its assets. In a carryover basis acquisition, the acquiring corporation will take a carryover basis in the assets acquired from the target corporation and the target corporation will recognize no gain. A carryover basis acquisition has essentially the same federal income tax consequences as a tax-free acquisitive reorganization under current law. The tax attributes of the target corporation will carryover to the acquiring corporation in carryover basis acquisitions but will not do so in cost basis acquisitions.

Proposal Three was premised on the repeal of General Utilities and the propriety of basing the special provisions of the tax law for acquisitive transactions on a direct and explicit trade-off of acquiring corporation basis for the target's assets and recognition of gain realized by the target corporation. Proposal Three was praised because the availability of tax-free treatment at the target corporation level will help avoid the so-called "lock-in" effect that may occur if the tax law always forced the target corporation to immediately recognize all gain realized in an acquisitive transaction./372/ James Eustice characterized the direct trade-off of acquiring corporation basis for the target's assets and the recognition or nonrecognition of gain realized by the target corporation as implementing sound and understandable tax policy which is consistent with other tax-free provisions of the Code. Eustice asserts that Proposal Three properly links these closely related and important issues for acquisitive transactions./373/

Many who testified supported the elective taxing regime envisioned by Proposal Three because it provides the corporations involved in a QA a clear choice and method for securing the desired corporate level tax consequences without having to resort to "legal gymnastics" to do so./374/ Other commentators supported Proposal Three because it allows all corporations to explicitly select the tax results available under the system of transactional electivity of the 1954 Code and thus make the tax law more economically efficient. Virtually all commentators agreed that the 1954 Code provisions are effectively elective at least for well-advised taxpayers and that the enactment of

Proposal Three will make the tax law for acquisitive transactions more horizontally equitable. Aidinoff stated that Proposal Three will help to eliminate traps for the unwary and will simplify the tax law for acquisitive transactions./375/ Aidinoff also stated that the repeal of General Utilities and the enactment of Proposal Three should eliminate the need for any sort of consistency rules governing which target assets can take a cost or a carryover basis in the hands of the acquiring corporation if the objective is to make the tax consequences of QAs neutral as to the legal form of the transaction. Aidinoff asserted the consistency rules under Section 338 have proved very complex and unworkable in practice and are premised on a severe overstatement of the practical ability of corporations and their advisers to tailor acquisitions as mixed stock and asset acquisitions designed to achieve maximum tax advantages./376/

Proposal Three follows Jacobs' observation that any critical analysis of tax-free reorganization treatment must address the issue of whether the provisions are effectively elective. If they are, and if a decision is made to continue allowing the tax consequences at both the corporate and shareholder levels now provided by the operative provisions for tax-free acquisitive reorganizations, Jacobs believes that Congress can enact the elective regime envisioned by Proposal Three or can base the tax law exclusively on the form of the transaction:

> . . . a formal elective procedure--whether through a mechanism such as that suggested by the [1977] American Law Institute's Subchapter C project or through a congressionally mandated directive to look exclusively to the form of a reorganization--could facilitate a more simplified and direct approach to the definitional problems posed by section 368(a)(1). If the election is effected by scrupulously following the form prescribed in the statute, both simplicity and certainty can be achieved./377/

The AICPA strongly disagreed with the proposition that the liberalization of the shareholder level nonrecognition rules for acquisitive transactions should be tied to "conceptually unrelated" issues particularly whether the <u>General Utilities</u> doctrine should be repealed./378/ The AICPA felt that the conditions for nonrecognition on the shareholder level present an entirely different and distinct tax policy issue than does <u>General Utilities</u>. The shareholder level recognition or nonrecognition issue has to do with whether or not the shareholders have sufficiently changed their economic position by an exchange of stock or securities to justify immediate recognition of gain or loss realized in an acquisitive transaction. The <u>General Utilities</u> issue has to do with defining the limitations on the double taxation of corporate income. The AICPA stated that it was not convinced that there is any causal relationship between <u>General Utilities</u> and shareholder level nonrecognition as assumed in the ALI Studies and the acquisition proposals./379/ The AICPA stated:

> The determination of shareholder level tax consequences on a separate shareholder basis divorced from traditional requirements of business purpose and continuity of proprietary interest also represents genuine simplification in the tax law and is appealing for that reason alone. However, in substance we believe the contemplated changes result in an expansion of the like-kind exchange provisions to include exchanges of stock and securities. Therefore its adoption should depend on the willingness of the Government to justify the deferral and potential permanent avoidance of shareholder level tax on the basis of the principles underlying section 1031. If the change cannot be justified in terms of sound tax policy, the continuity of interest requirement and other judicially-imposed requirements may have to be retained to establish the standards for shareholder level recognition./380/

The AICPA expressed its opinion that the repeal of General Utilities is an unwarranted expansion of the corporate tax base and the adoption of the acquisition proposals in the Act will inevitably lower the value of corporate assets and stock because any reasonable analysis of the present value of the benefits and detriments of making a cost basis election for a QAA or a QSA strongly suggests that virtually no QAs would be carried out as cost basis acquisitions./381/ The AICPA also expressed its strong disagreement with having the repeal of General Utilities serve as the quid pro quo for the liberalization of the nonrecognition provisions for shareholders. The AICPA felt this linkage is manifestly unfair because it would force all shareholders to shoulder the cost of deferred recognition of gain for those target shareholders arranging to receive stock or securities instead of nonqualifying and immediately taxable consideration from the acquiring corporation./382/ In testifying on the final acquisition proposals, the AICPA stated that the acquisition proposals are premised on the repeal of General Utilities and, on balance, are no better and perhaps worse than existing law./383/

The AICPA was very critical of the repeal of General Utilities as the centerpiece of the acquisition proposals, particularly the elective taxing and basis regime at the corporate level. In spite of all the rhetoric about this doctrine, the AICPA felt its retention or rejection should be based on the somewhat philosophical issue of the extent of the double tax scheme and not conceptually unrelated areas such as whether the shareholders of the target corporation should receive tax-free treatment upon receipt of stock of the acquiring corporation and whether the acquiring corporation should receive a stepped-up basis in the stock or assets of the target. The AICPA stated that the disposition of General Utilities is not likely to be resolved through the determination of a theoretically correct answer because there may not be one./384/

The AICPA stated that despite the alleged symmetry and other benefits (e.g., reduction in complexity and reduction in the incentives to enter into artificially structured tax-motivated transactions designed to exploit General Utilities, and the institution of a more rational and better understood taxing regime for acquisitive transactions), corporations will not be equally likely to make either cost basis or carryover basis acquisitions. The AICPA asserted that a well-advised corporation will almost never make a cost basis election for a QA unless the target corporation has net operating loss carryforwards which can be used to offset all or part of the immediately recognized gain resulting from a cost basis election./385/

The AICPA raised a number of objections to the apparent theme of using the repeal of General Utilities to somehow justify or pay for making the corporate level tax consequences of a qualified acquisition explicitly elective. The AICPA does not accept the basic premise of Proposal Three that permitting the acquiring corporation to elect cost basis in the assets or stock of the target requires that a step-up to fair market value must be matched by complete recognition of the gain in the target's assets by the target corporation. The AICPA testified:

> Assuming, *arguendo*, the validity of this logic, it has either escaped notice or has been rejected by Congress for more than 60 years during which time General Utilities and cost basis have coexisted under sections 336 and 337 (and predecessor provisions). During this time, Congress has clearly supported a policy of limiting double taxation of corporate profits primarily to ongoing corporations. We find no clear policy reason to change such a long standing

> position. In fact, at this very time, the President is recommending, and Congress is considering, a relaxation of the double taxation rule as it applied to ongoing corporate operations. The President has stated in support of his proposals that double taxation discouraged investors 'from using the corporate form, even in circumstances where nontax considerations make it desirable.' We believe that this rationale especially applies to the imposition of a double tax on the sale and liquidation of a corporate business./386/

Proposal Four

> The Act provides that the shareholder level consequences of a qualified acquisition will be determined independently of the corporate level tax consequences and independently of any election made at the corporate level. In addition, the Act provides that the tax consequences to each shareholder will be determined independently of the tax consequences to other shareholders.

Many who testified before Congress expressed support for unlinking the corporate and shareholder level tax consequences of QAs and allowing each shareholder to determine his tax consequences independently of the other shareholders./387/ The AICPA supports Proposal Four because determining the shareholder level tax consequences of QAs on a shareholder-by-shareholder basis and without regard to the judicial doctrines applicable to tax-free reorganizations will greatly simplify the tax law./388/

Others stated that separating the corporate and shareholder level tax consequences of QAs is very desirable because the linkage in present law for tax-free reorganizations cannot be explained as a natural consequence of the traditional tax policies underlying the taxation of acquisitive transactions./389/ James Eustice was very supportive of Proposal Four because it would eliminate tax traps for the unwary in the present law (e.g., target shareholders who receive only acquiring corporation stock in a purported tax-free reorganization may nevertheless have to immediately recognize all gain realized if the overall transaction is not a reorganization) and would obviate the need for the parties to resort to manipulation of the legal form of the transaction to achieve desired tax results./390/ The firm of Arthur Andersen supported Proposal Four because it would simplify the tax law, make the law more predictable, and more equitable./391/

Researcher's Comments

As discussed in Chapter III and the Appendix to this Chapter, neither empirical nor policy-oriented researchers can presently identify or rank the various economic, financial, and other reasons why corporations become participants in acquisitive transactions. It is thus difficult, if not impossible, to make definitive statements about the macroeconomic or microeconomic consequences of the enactment of the acquisition proposals contained in the Subchapter C Revision Act or any other major comprehensive tax reform proposals. Due to the inherent inability to quantify the extent to which the acquisition proposals implement the major goals and subgoals of comprehensive tax reform efforts for acquisitive transactions, it is also difficult to state precisely the extent to which enactment of the acquisition proposals would improve Subchapter C of the 1986 Code.

As the methodological and tax literature and testimony before Congress on the acquisition proposals strongly suggest, policy-oriented researchers are frequently limited to studying the nature of the explicit and implicit tax policies in the present law, evaluating experiences and problems under the present law, studying the explicit and implicit tax policies in the proposed changes, and making logical inferences about whether enactment of proposed changes satisfies generally accepted objectives of the comprehensive tax reform effort. It is possible that the general provisions and structural factors of the federal tax laws and the specific provisions governing acquisitive transactions play a disproportionate role in acquisitive transactions and that empirical researchers have not yet developed the requisite research designs or analytical techniques to measure the influence on the tax law on acquisitive transactions. It is also possible that with access to confidential corporate tax return information and other information normally available only to officers of a corporation, empirical researchers could construct more realistic models of the corporate takeover process and thus be able to better operationalize and isolate the role of federal tax provisions in acquisition decisions. The empirical and policy-oriented research published to date does not support these conclusions and provides reasonably strong support for the conclusion that the federal income tax law has not played a disproportionate role in merger and acquisition decisions even in the megamerger wave of the 1980s.

Given these methodological problems and limited availability of necessary data, comprehensive tax reform of the taxation of acquisitive transactions should follow the philosophy of Treasury I and Treasury II and attempt to implement the major goals of economic efficiency and horizontal equity. Comprehensive tax reform for acquisitive transactions should be less concerned with making the tax law simple because this is not possible and the most pressing tax policy need in the post-General Utilities world is economic efficiency. The ALI studies and the acquisition proposals either implicitly or explicitly assumed that the tax law should continue to allow tax-free restructurings or rearrangements of corporate businesses at the corporate and shareholder and security holder levels based on concerns about economic efficiency, wherewithal-to-pay, and the long-standing acceptance of the principle of tax-free exchanges accompanied by special carryover and substituted basis rules.

As is the case for the 1986 Code generally, the ALI studies and the acquisition proposals do not attempt to equate the present value of tax benefits and costs for acquisitive transactions. Commentators who criticize the elective tax regime at the corporate level because the present value of an immediate dollar of tax liability avoided in a carryover basis QA by the target corporation is not equal to the present value of future tax benefits forgone by the acquiring corporation by not taking a stepped-up basis in the target's assets are correct. Until the entire Code is indexed for inflation and enacts tax provisions which explicitly consider the time value of money, these criticisms do not seem particularly relevant given the long-standing and continuing use of tax-free provisions and related special basis rules (e.g., Section 351, Section 1031, and Section 1034 of the 1986 Code).

Congress must address several basic tax policy questions for acquisitive transactions. Perhaps the most important is balancing the objective of economic efficiency and the need for certainty and predictability in Subchapter C. The TRA of 1986 and the Revenue Act of 1987 did little to simplify the taxation of acquisitive transactions. Congress could decide not to make any additional changes and take the position that although the 1986 Code provisions may be economically inefficient, making no changes for some period of time would allow taxpayers and their advisers to structure acquisitive transactions based on the weak form of taxation enacted in the TRA of 1986.

Another important tax policy issue is whether the system of transactional electivity and the existence of categorical distinctions between reorganizations and nonreorganization acquisitive transactions should be continued or whether they should be replaced with the broader and more functional definition of a "qualified acquisition" and elective taxing regime envisioned in the Subchapter C Revision Act. Both the broader definition of a QA and the elective taxing regime are intended to eliminate the system of transactional electivity and the categorical distinctions between various types of economically similar acquisitive transactions.

Although there are a few exceptions (e.g., allowing carryover basis treatment even if the acquiring corporation uses all cash consideration in a QA), the acquisition proposals do not provide radically different corporate or shareholder level tax consequences than are available under the 1986 Code. The acquisition proposals do expand the number of transactions potentially eligible for tax-free treatment. Allowing the corporate and noncorporate parties to an acquisitive transaction to obtain these tax results without having to manipulate the legal form of the transaction is intellectually appealing and would improve the economically efficiency of the tax law.

The "fictions" of the present tax law applicable to acquisitive transactions (e.g., that the judicial doctrines for tax-free acquisitive reorganizations continue to be necessary as a matter of tax policy to distinguish taxable sales and tax-free transactions) clearly introduce many complexities into Subchapter C and should be retained only if absolutely necessary. The major tax policy problem caused by the continued use of the these judicial doctrines as prerequisites for tax-free treatment is that they link the corporate and shareholder tax consequences of acquisitive transactions--a situation which should not logically occur if the overriding goal is to divorce tax treatment from the legal form of the transactions in order to improve the economic efficiency and horizontal equity of the tax law.

The repeal of the General Utilities doctrine in the TRA of 1986 implemented the weak form of taxation for acquisitive transactions and improved the symmetry of the tax law at least for taxable acquisitions. The manner in which General Utilities was repealed exacerbated the differences in the tax consequences of taxable and carryover basis acquisitions, created a number of undesirable tensions in Subchapter C of the Code, and upset the rough equilibrium that existed between the individual and corporate tax provisions. If the overriding tax policy goals for acquisitive transactions are economic efficiency and horizontal equity, Congress should now seriously consider conforming the federal income tax consequences of economically similar transactions and make the tax consequences as independent of the legal form of the transaction as possible. If the tax law is to continue to provide tax-free provisions for acquisitive transactions at both the target corporation and the target shareholder and security holder levels, both economic efficiency and horizontal equity require that treatment should be more readily and easily available to all taxpayers, particularly those who are not fortunate enough to be well-advised and well-financed.

The TRA of 1986 clarified the relationships between the complete liquidation and tax-free acquisitive reorganization provisions and, together with the elimination of lower tax rates for long-term capital gains, has done much to reduce the attractiveness of liquidation-reincorporation transactions. These changes improved the horizontal equity of the tax law; Congress should now continue this effort.

Congress faces a dilemma in accomplishing these goals. The acquisition proposals will liberalize the 1986 Code by allowing tax-free treatment for more acquisitive transactions and are quite likely to be revenue-losers. The mandatory Section 338 approach will provide harsher tax results than the 1986 Code and is quite likely to be a revenue-gainer. Implementing either approach would be difficult and would raise a number of technical issues and problems because each alternative deviates from some long-standing federal income tax principles. Enactment of the acquisition proposals follows logically from one of the basic arguments for broadening the tax base and lowering marginal tax rates: if Congress cannot determine the effects of federal tax laws, allowing taxpayers more flexibility may complicate the Code but will improve the economic efficiency of the law.

The issue of whether a proposed change in the tax law should be rejected (or not even considered) by Congress solely or primarily because it is likely to be a revenue-loser has been discussed in the tax literature. As might be expected, commentators agree that _in theory_ the issues of whether a proposal satisfies generally accepted general and specific comprehensive tax reform or tax simplification criteria should be divorced from the anticipated effects of the proposal on the federal tax revenues. In practice, however, the enactment of the TRA of 1986 and the Revenue Act of 1987 clearly suggest that Congress does not intentionally enact major revenue-losers unless there is clear and convincing evidence that such a change is needed to prevent systematic abuse of the tax law or other important public policies. Some commentators believe by repealing the _General Utilities_ doctrine Congress enacted a revenue-gainer without clear and convincing evidence that the change was absolutely necessary and without knowledge of all the economic and other consequences. As discussed in Chapter V of this Study, if the Treasury Department's Subchapter C Report mandated by the TRA of 1986 does not provide overwhelming support for the need to enact the acquisition proposals based on pressing tax policy concerns, Congress is not likely to consider enacting them in the near future.

Chapter V: Conclusions and Implications for Additional Research

The merger wave of the 1980s has caused Congress and the business press to become very interested in the economic and social consequences of acquisitive transactions and leveraged buyouts. Researchers with varied backgrounds have explored the interrelated consequences of corporate takeovers and divestitures./1/ The megamerger wave of the 1980s, the more recent leveraged buyout boom,/2/ and persistent federal budget deficits/3/ all suggest that Congress may eventually be forced to reconsider a number of fundamental tax policy issues and problems (and the related technical provisions) for economically similar acquisitive transactions. Two of the most fundamental sets of tax policy issues are balancing the often competing objectives of equity and simplicity and trying to encourage economic efficiency and stimulation of specific activities.

Congress is properly concerned with providing federal income tax consequences for various types of acquisitive transactions which are horizontally equitable (i.e., providing the same tax consequences for economically similar transactions and making any incentives provided by the tax law available to all taxpayers) and simplified (i.e., providing clear, consistent, certain, and predictable federal income tax consequences for economically similar acquisitive transactions). Because of the frequent elevation of legal form over economic substance in Subchapter C,/4/ particularly for acquisitive transactions,/5/ continued reliance on long-standing notions of equity or fairness may well conflict with achieving simplicity, certainty, and predictability./6/

Congress is also properly concerned with balancing one longstanding objective that the provisions of the Internal Revenue Code should not interfere with economically necessary and socially desirable acquisitive transactions and corporate restructurings with another long-standing objective that the tax law be as economically efficient as possible. Thus Congress must enact tax laws designed (1) to distinguish acquisitive transactions which should or should not receive favorable tax treatment and (2) to be as neutral as possible between the various legal forms of an acquisitive transaction and their economic substance (i.e., the tax laws should not reward certain types of acquisitive transactions or corporate restructurings and penalize others). Posin's comments on the present tax-free reorganization provisions illustrate these problems:

> The present system for taxing corporate reorganizations has evolved into an ungainly, complex body of

> law. In the early days of the development of this law, there were two theories of how these transactions should be taxed. One held that there should be just general, simple rules that the courts could interpret. The disadvantage of this theory was the lack of predictability of results. The other theory held that there should be a detailed statute covering all contingencies. The disadvantage of this view was that the statute would have to be extremely complex. Remarkably, the system has evolved to the disadvantages of both theories. This web fair Penelope has spun does indeed ravel and unravel./7/

Balancing these competing sets of objectives has proven to be extremely difficult and, in the opinion of many commentators, has not been achieved in either the 1954 or the 1986 Codes. It is by no means certain that enactment of the acquisition proposals contained in the Subchapter C Revision Act of 1985 (the Act) will accomplish these goals. Given the evolution of the corporate income tax law in the United States, it is almost impossible to separate the legal form of a transaction from its economic substance for the real-world issues of enacting and enforcing corporate tax laws. Stated more theoretically, the corporate tax law in the United States is based almost exclusively on positive rather than normative theories and concepts./8/ In commenting on the role of form in Subchapter C, James Eustice states:

> more often than not, the transactional form _is_ the substance in the world of subchapter C . . . however, that mere form, however important, will not always carry the day./9/

As discussed in Chapter IV of this Study, proponents of the acquisition proposals assert that the only realistic manner in which lasting tax reform for acquisitive transactions can be achieved is to base the tax law on the legal form of a transaction. In arguing for the simplification of the tax-free reorganization provisions in 1980, Jacobs stated:

> I believe in simplicity--I truly believe in it. In its cause, I am willing:
>
> (1) To concede the existence of anomalies;
> (2) To eschew the temptation to attempt to divine the 'right' answer; and
> (3) To accept the principle that the price one must pay for certainty and predictability of result in tax-free [acquisitive] corporate reorganizations is that form must be accorded an all but irrefutable presumption of governance.
>
> Last, and perhaps most important, the temptation to compare and reconcile an endless variety of transactional forms yielding irreconcilable tax results must be resisted. We should not permit our desire to treat substantially similar transactions similarly to become the touchstone of reorganization treatment./10/

As discussed throughout this Study, Congress has historically provided favorable treatment for tax-free acquisitive reorganizations. The 1954 Code provided favorable tax treatment for complete liquidations and certain acquisitions of target corporation stock which the acquiring corporation elects to treat as an acquisition of the underlying assets. The federal income tax applicable to acquisitive transactions is complex, elevates legal form over economic substance, and has been the subject of previous comprehensive tax reform efforts. As Jacobs and other commentators suggest, the most pragmatic alternative may be for Congress to accept the importance of the role of legal form and base the tax law for acquisitive transactions on it. Or, as the Act suggests, Congress may enact an explicitly elective corporate level taxing regime designed to divorce legal form from tax consequences to the maximum extent possible.

In spite of convincing evidence that using the federal income tax laws to achieve nontax objectives makes the law more complex and economically inefficient, Congress continues to enact the federal income tax laws designed to stimulate certain activities deemed economically beneficial and socially desirable./11/ Much debate and controversy exists over fundamental tax reform issues such as the taxation of capital gains./12/ The 1989 debates and Congressional hearings on whether the federal income tax laws should be altered to discourage leveraged buyouts and other highly leveraged transactions reinforces the conclusion that, after the repeal of the 1954 Code provisions which codified the General Utilities doctrine in the Tax Reform Act of 1986 (TRA of 1986), Congress and corporate tax reformers are much more concerned about the taxation of divisive transactions and corporate distributions to shareholders than about the taxation of acquisitive transactions./13/

In many respects, the development and evolution of the acquisition proposals which were the subject of this

Study are a textbook example of how the comprehensive tax reform process in the United States should proceed. Various individual commentators and professional organizations, notably the American Institute of Certified Public Accountants and the American Law Institute, performed detailed and exhaustive studies of Subchapter C and issued their recommendations for improvements in the tax law for acquisitive transactions. The staff of the Senate Finance Committee performed an independent study of the 1954 Code provisions for acquisitive transactions. The most recent (1982) American Law Institute Study and the staff of the Senate Finance Committee reached very similar conclusions as to how to resolve the principal tax policy and technical problems for acquisitive transactions broadly defined. The staff of the Senate Finance Committee drafted a preliminary report, held public hearings, drafted a final report which included suggested statutory language and examples of how the proposed law would operate, and held public hearings on the final report. A comparison of the 1982 American Law Institute Study, the preliminary report and the final report of the staff of the Senate Finance Committee reveals only minor differences.

The tax and other relevant literature indicates the existence of many problems in the current tax law for tax-free reorganizations and economically similar acquisitive transactions. Many commentators believe the repeal of the

1954 Code provisions which codified the General Utilities doctrine without enacting the acquisition proposals or making the other changes recommended in the Act is incomplete tax reform which must be remedied. Many of these commentators believe Congress should enact the acquisition proposals contained in the Act. Other commentators believe the acquisition proposals are no better than the present law and have expressed concern that their enactment would create more complexity, confusion, and uncertainty in Subchapter C than presently exists. The tax literature and the Congressional hearings on the proposals indicate that certain aspects of the acquisition proposals (e.g., the elimination of the present tax-free reorganization definitions and the repeal of the continuity of interest, continuity of business enterprise, and business purpose doctrines) would rationalize tax policy and the related technical provisions, make the tax law more horizontally equitable and more economically efficient.

Other commentators believe that other aspects of the acquisition proposals (e.g., the elective corporate level taxing regime and the separation of corporate and shareholder level tax consequences for acquisitive transactions) would not make the tax law simpler, would not reduce the need for skilled tax advisers, would make the tax law depart too far from traditional notions of realization and recognition, and may encourage taxpayers to engage in tax-free acquisitive transactions to a greater extent than does the 1986 Code.

Several commentators question whether the elective tax regime and liberalization of the tax law for acquisitive transactions (i.e., allowing more transactions to be eligible for tax-free treatment than under the 1986 Code) envisioned by the acquisition proposals will simplify the tax law and make the tax law more horizontally equitable. Virtually all commentators agree that in the post-General Utilities world, enactment of the acquisition proposals will be a revenue-losing proposition because few well-advised acquiring corporations engaging in a qualified acquisition would elect cost basis treatment. Thompson's comments are typical:

> It would appear that if the 1985 SFC [Senate Finance Committee] Proposals are adopted, there will be few Cost Basis Acquisitions, because, except where the target has significant net operating losses, the discounted present value of the tax benefits to be received from a cost election will not offset the tax that will be due on making the election. Further, it is difficult to imagine that any [well-advised] taxpayer would make a Cost Election without also making the election for carryover basis treatment of intangibles./14/

Whether the acquisition proposals are ultimately enacted by Congress depends on whether they will simplify the tax law applicable to acquisitive transactions,/15/ are perceived to be revenue-gainers or revenue-losers, are needed to deal with a clearly abusive situation, can be demonstrated not to cause far-reaching dislocations in the national securities markets/16/, have strong support from the Treasury Department and the professional tax community, and can be sold politically./17/ In the current deficit reduction environment, tax legislation having a high probability of being a major revenue-loser has a very small probability of being enacted./18/

The empirical research has not demonstrated that the federal income tax laws applicable to acquisitive transactions have been systematically abused by taxpayers and their advisers or have played a disproportionate role in management decisions to engage in acquisitive transactions./19/ The lack of empirical support for the proposition that the federal income tax laws have fueled the megamerger or leveraged buyout booms makes it much more difficult to convince Congress that enacting the proposals contained in the Act is an immediate and pressing tax reform issue. Anecdotal evidence suggests that the provisions of the 1986 Code often are only a minor consideration in planning corporate divestitures./20/ Many commentators believe that the repeal of the General Utilities doctrine has resolved the obvious lack of symmetry between gain recognition by the target corporation and the tax basis of the target's assets in the hands of the acquiring corporation and removed one of the principal incentives to engage in certain types of acquisitive transactions./21/

Section 634 of the TRA of 1986 required the Treasury Department to study Subchapter C problems and to submit comprehensive tax reform proposals to the appropriate Congressional committees by January 1, 1988. Because the acquisition proposals contained in the Act are an unresolved Subchapter C issue, they will presumably receive further consideration by the Treasury Department in its Subchapter C Study.

Although the Subchapter C Study was to have been completed by January 1, 1988, it has not yet been issued. In a press release issued in April 1987,/22/ the Treasury Department listed the issues which it will address in its Subchapter C Study. The press release included the following "Operating Rules of Subchapter C," suggesting that at least some of the tax policy issues addressed by the acquisition proposals may receive additional consideration by the Treasury Department:

II. B 1 Requirement of corporate level gain upon liquidation/acquisition

2 Extent to which corporate level gain should be deferred/recognized upon acquisition of corporation's stock/assets

a. Relation to shareholder level consequences and/or form of acquisition

b. Appropriateness of elective corporate level recognition/nonrecognition

III. C 1 Possible separation of shareholder level tax consequences from corporate level tax consequences

2 Timing of shareholder level income recognition in connection with corporate reorganizations

   a. Nature of the consideration received by the shareholders

   b. Need for common law doctrines of continuity of business enterprise and continuity of proprietary interest

Yin has characterized the Treasury Department as a somewhat unwilling participant in the entire Subchapter C reform project which commenced with the publication of the detailed study of Subchapter C problems by the American Law Institute in 1982. Yin suggests that the Treasury Department has five choices in preparing its Subchapter C Study:

1. Ignore the mandate, or delay responding to Congress indefinitely;

2. Interpret the mandate narrowly by issuing a report devoid of any major recommendations. Do not take a position on conforming the tax results of asset and stock acquisitions;

3. Issue a report essentially recommending retention of the status quo, perhaps combined with a few technical proposals on peripheral issues;

4. Propose the adoption of a mandatory section 338 regime for stock acquisitions, whereby all qualifying stock acquisitions would automatically trigger both corporate level and shareholder-level gain and loss; or

5. Recommend the adoption of the acquisition proposals contained in the Act and which were the subject of this Study./23/

On February 13, 1989, a press release stated that the House Ways and Means Committee has requested its Subcommittee on Select Revenue Measures to review a number of issues during the 101st Congress including the Subchapter C Study mandated by the TRA of 1986:

> Subchapter C Study: The Subcommittee will continue its consideration of whether any further changes are appropriate to Subchapter C of the Internal Revenue Code in light of revisions made by the Tax Reform Act of 1986. Such issues include any changes which may be advisable given the repeal of the General Utilities doctrine and other significant changes contained in that Act. The Subcommittee will continue to review whether the provisions of the 1986 Act are being properly interpreted in a manner promoting the policies of that Act./24/

The tax literature suggests that the Subchapter C Study is "on hold" during the current leadership vacuum in the Treasury Department./25/ Tax Legislative Counsel Paul states the future policy direction of the Study will not be determined until a new Assistant Treasury Secretary for Tax Policy is appointed and in place. Although substantial staff effort has been devoted to completing the Subchapter C Study, Paul states the Subchapter C Study has been overshadowed by the leveraged buyout issue and the overall impact of the repeal of the General Utilities doctrine in the TRA of 1986. Paul also states the Subchapter C Study will not attempt to address every possible tax reform issue for Subchapter C and that the major topics which will be included in the final Study will include the ramification of the repeal of the General Utilities doctrine, debt/equity issues, and choice of entity issues./26/

The absence of the acquisition proposals from the major topics to be discussed in the report on Subchapter C indicates the relatively low importance placed on them by the Treasury Department. Tax Legislative Counsel Paul's observation that the passage of time and the repeal of the General Utilities doctrine has made completion of the Study more difficult because many of the assumptions on which the Act and the acquisition proposals were based (e.g., that capital gains would be taxed at a lower rate than ordinary income) are now questionable or incorrect/27/ also supports the conclusion that the Treasury Department is not likely to enthusiastically support the acquisition proposals when and if the Subchapter C Study is issued.

The firm of Arthur Andersen concludes that many Congressmen have accepted the Treasury's 1985 testimony on the final acquisition proposals that (1) the corporate level nonrecognition provisions which codified the General Utilities doctrine were primarily responsible for any systematic "tax abuse" which occurred under the 1954 Code, (2) the tax-free reorganization provisions have not been systematically abused, and (3) although the acquisitive provisions of the 1986 Code may need "technical correction" (e.g., to deal with the needlessly complex and conflicting tax-free reorganization definitions), the major changes and liberalization of the tax law for acquisitive transactions envisioned by the acquisition proposals are not warranted. Arthur Andersen thus concludes that it is very unlikely that the acquisition proposals contained in the Act will ever be enacted by Congress./28/

Other commentators also believe the likelihood that the acquisition proposals will ever be enacted by Congress is remote. Leduc and Gordon, for example, assert that the absence of a strong and effective constituency for enactment of the acquisition proposals, valid tax policy criticisms, and the high probability that their adoption would significantly reduce tax revenue from C corporations in the short run (because very few qualified acquisitions would be coupled with a cost basis election) are likely to prevent the acquisition proposals from ever being enacted./29/

Leduc and Gordon criticize the Treasury Department because it did not take a leadership role in persuading Congress to seriously consider and evaluate the acquisition proposals in the deliberations leading up to the passage of the TRA of 1986 and the Revenue Act of 1987. Leduc and Gordon state that Treasury allowed Congress to focus on the repeal of the <u>General Utilities</u> doctrine instead of the main tax policy issues addressed by the Act./30/ Leduc and Gordon interpret the deliberations leading up to the enactment of the Revenue Act of 1987 as having rejected the proprietary of the elective taxing regime at the corporate level which is based on a direct trade-off of acquiring corporation basis in target assets and target corporation recognition of gain envisioned by the acquisition proposals./31/ Thus unless the Treasury Department's Subchapter C Study mandated by the TRA of 1986 makes very strong and persuasive arguments that the acquisition proposals should be reconsidered, they are not likely to become a part of Subchapter C of the Internal Revenue Code.

Future Tax Research

This Study supports the need for additional tax policy research for acquisitive transactions broadly defined and demonstrates the appropriateness of the policy determination (inductive) and policy impact (deductive) research approaches described in Chapter II. Experimental/32/ and case study research/33/ have also been used successfully in tax policy studies. The continued importance of acquisitive transactions to the United States economy, the existence of many unresolved tax policy issues for such transactions, and the virtually certainty that Congress will enact "tax reform"/34/ and "tax simplification" measures/35/ in the future make the research projects suggested below interesting and necessary. Growing Congressional interest in alternative tax systems (e.g., consumption taxes) also makes tax policy research appropriate and necessary./36/

Anecdotal evidence suggests that some academic research is totally divorced from real-world issues and makes no attempt to find solutions to real-world problems./37/ Researchers interested in studying federal income tax and in other important public policy issues which are firmly grounded in reality must be convinced that the results of such studies really matter in shaping and implementing public policies./38/

Research Approaches: Empirical (Positive) v. Policy (Normative)

Tax researchers (particularly accountants) face a potential dilemma in demonstrating the need for, the validity of, and the significance of contributions resulting from tax policy research. Academics and others concerned with research methodology generally agree that a theory should explain observed practice and predict unobserved phenomena./39/ One of the most fundamental issues facing a researcher is deciding whether positive research (i.e., empirical research directed at discovering how the world operates) or normative research (i.e., policy research directed at discovering prescriptions or solutions to various problems) is the more effective means of investigating specific problems of interest to the researcher and, more generally, advancing knowledge./40/

A careful reading of the financial accounting, auditing, and tax literature clearly suggests that financial accounting research and auditing research have made a number of advances by moving away from normative (prescriptive) research and moving toward empirical (positive) research./41/ Much of the contemporary empirical accounting and auditing/42/ research is based on "positive theory" and related methodologies including sophisticated statistical, multivariate, and other quantitative techniques./43/

Much of the contemporary tax research is similarly designed to determine how the world works in specific situations and utilizes similar statistical and other techniques./44/ The tax literature suggests that limitations of the availability of data and the ability to operationalize and quantify traditional tax policy objectives and concepts such as equity, simplicity, and economic efficiency limit the ability of tax researchers to perform empirical research along the lines of positive research in financial accounting and auditing./45/ The corporate takeover and public policy literature suggests that because policy makers typically operate in an environment of partial ignorance, empirical research can help policy makers to make more appropriate decisions./46/

Because corporate tax law is based almost exclusively on positive rather than normative theories,/47/ the nature of the tax law as well as problems of interest to practitioners may call for positive research to explain why the law is as it is. But the nature of many of the tax policy problems, the limited availability of data and the inability to operationalize key tax concepts such as equity and simplicity dictate the use of traditional tax policy methodologies used in this Study. As discussed in Chapter II, there are, however, valid reasons to pursue tax policy research./48/

Potential Tax Policy Studies

1. How does financial accounting and corporate financial reporting for business combinations interact with the regular and alternative minimum tax provisions and, more generally, with the incentives to engage in acquisition transactions?/49/
2. Can regulatory theories be utilized to assist in tax reform efforts for the taxation of acquisitive transactions?/50/
3. Does Congressional concern with the revenue potential of proposed tax legislation and the willingness to utilize the Internal Revenue Code to stop takeovers and unpopular tactics lead to improved tax policies?/51/
4. Assuming the acquisition proposals are not enacted, should Congress act to conform the federal income tax consequences of stock and asset acquisitions?/52/
5. Assuming Congress does not enact the acquisition pro-

posals and does not conform the tax consequences of stock and asset acquisitions, how can corporations and their shareholders utilize the tax-free and tax-deferred areas of the tax laws to minimize the effect of the expanded tax bases and the corporate alternative minimum tax provisions?/53/

6. What is the role of Section 355 in the post-<u>General Utilities</u> world?/54/
7. What role should information economics play in the formulation of tax policies?/55/

The possibilities for future tax research appear infinite given the changing nature of that growing organism-the federal income tax system.

Appendix A

Historical Development of Reorganization Provisions

Neither the Revenue Act of 1913,/1/ the Revenue Act of 1916,/2/ nor the Revenue Act of 1917/3/ contained statutory definitions of, or special operative rules applicable to, a class of transactions known as "tax-free reorganizations."/4/ The corporate and individual participants in corporate "reorganizations" were not initially granted an exemption from the general rule that gains realized upon the sale or exchange of property or stock should be immediately recognized./5/

The earliest Supreme Court decisions/6/ for transactions now included in the category of "tax-free reorganizations" involved the refinancing of a single corporation. These decisions included United States v. Phellis,/7/ Rockfeller v. U.S.,/8/ Cullinan v. Walker,/9/ Weiss v. Stern,/10/ and Marr v. U.S../11/ Although these early decisions did not involve acquisitive transactions, they played an extremely important role in the development of the early statutory definitions of and operating provisions for acquisitive reorganizations and the judicial doctrines which soon became prerequisites for tax-free reorganization treatment/12/ because Congress was reluctant to impose a tax on "paper gains" realized by the shareholders and security holders of the target corporation/13/ and because Congress did not initially enact the sophisticated tax-free reorganization provisions found in the 1986 Code./14/ Several commentators have criticized Congress for enacting very favorable tax expenditure provisions/15/ for acquisitive reorganizations based on the early Supreme Court decisions./16/

Section 202(b) of the Revenue Act of 1918/17/ prevented the immediate recognition of gain realized by the shareholders and security holders of the target corporation in the exchanges incident to a "reorganization" if such gains were due to "purely paper transactions."/18/ Although the Act did not define the term "reorganization," commentators suggest Congress intended to provide nonrecognition treatment for the "paper gains" realized in transactions in addition to statutory mergers and consolidations./19/

Most commentators agree the Revenue Act of 1918 was a very primitive attempt in the ongoing battle to distinguish taxable sales and tax-free reorganizations. Ferrero notes:

> Under the 1918 Act, the taxpayer was in the enviable position of being able to claim that anything short of an outright cash sale qualified as a reorganization. While subsequent reenactments of the reorganization provisions have added specific [continuity of interest] requirements for certain types of ex-

> changes to qualify as reorganizations, the statute is still silent as to the requirements for others./20/

The Revenue Act of 1921/21/ clarified the statutory definition of reorganizations. The Committee Reports accompanying the Act stated the revised definitions and operative provisions would:

> not only permit businesses to go forward with the readjustments required by existing conditions but [would] also considerably increase revenue by preventing taxpayers from taking colorable losses in wash sales and other fictious exchanges./22/

In enacting the Revenue Act of 1921, Congress was primarily concerned with the nature of property transferred by the target corporation to the acquiring corporation rather than the nature of the consideration given by the acquiring corporation to the target or its shareholders. Congress apparently continued to assume that the sole or primary type of consideration which would be routinely used in reorganizations would be stock of the acquiring corporation./23/

Holzman regards Section 202(c)(2) of the Revenue Act of 1921 as the first comprehensive attempt by Congress to provide specific federal income tax consequences for corporate reorganizations./24/ Neither the Revenue Act of 1918 nor the Revenue Act of 1921 provided a specific provision, such as Section 361 of the 1986 Code, stating that gain realized by the target corporation upon its transfer of property to the acquiring corporation would not be immediately recognized. The Regulations/25/ construed the language of Section 202(b) of the Revenue Act of 1921 to provide this result.

The Revenue Act of 1921 did not provide a carryover or substituted basis rule for the property or stock received in the exchanges incident to a reorganization. Section 202(a) of the Revenue Act of 1921 provided a cost basis rule under which the tax basis of property or stock received in a reorganization was equal to the fair market value of the consideration given whether or not the target corporation or its shareholders recognized any of the gain realized in the exchanges incident to the reorganization. Posin states:

> Alert taxpayers and their advisers pounced on this opportunity to obtain a tax-free step-up in the basis of appreciated stock or property, simply by involving such property in a qualifying tax-free reorganization. This higher basis would be of great use to taxpayers in further calculations of gain or loss on the property, as well as in calculations of depreciation and cost depletion./26/

The Revenue Act of 1924/27/ adopted the policy of the 1939, 1954, and 1986 Codes in specifically exempting the gain realized on the exchanges incident to tax-free reorganizations from immediate recognition./28/ Congressional concern that the federal income tax laws could interfere with rational business decisions and long-term business planning is evident in the Reports of the House Ways and Means Committee and the Senate Finance Committee:

> Congress has therefore adopted the policy of exempting from tax the gain from exchanges made in connection with a reorganization, in order that ordinary business transactions will not be prevented on account of the tax law. If it is necessary for this reason to exempt from tax the gain realized by shareholders, it is even more necessary to exempt from tax the gain realized by the [target] corporation./29/

In enacting the Revenue Act of 1924 Congress expressed concern that astute tax lawyers could turn taxable sales into tax-free reorganizations./30/ Congress thus attempted to provide a more detailed and internally consistent tax law./31/ Many commentators note the Revenue Act of 1924 contains the nucleus/32/ or embryo/33/ of the definitional/34/ and operative provisions/35/ for tax-free reorganizations contained in the 1986 Code. Congress did not change the statutory definitions of transactions qualifying as reorganizations until the Revenue Act of 1934./36/

Neither the Revenue Act of 1926/37/ nor the Revenue Act of 1928/38/ made any important changes to the tax law for reorganizations. Many commentators agree that, with the exception of triangular "A" mergers provided for in Section 368(a)(2)(D) in 1968,/39/ reverse triangular "A" mergers provided for in Section 368(a)(2)(E) in 1971,/40/ and the changes enacted in Section 361 reflecting the repeal of the General Utilities doctrine in the Tax Reform Act of 1986,/41/ the current federal income tax law for tax-free acquisitive reorganizations is quite similar to that contained in the Revenue Act of 1934./42/

The Revenue Act of 1936/43/ and the Revenue Act of 1937/44/ did not alter the reorganizations provisions of the Revenue Act of 1934. In comparing the Revenue Act of 1934 with the codification all federal income tax laws in the Internal Revenue Code of 1939/45/ one notes no change in either the statutory definitions/46/ or in other important definitions such as a party to the reorganization/47/ or control./48/ The operative provisions applicable to the shareholders and security holders of the target corporation are essentially the same/49/ as are those applicable to the corporate parties to the reorganization./50/

The enactment of the Internal Revenue Code of 1954/51/ represented a rearrangement and expansion of the federal income tax law. Unlike other areas of the federal income tax law applicable to corporations and their shareholders, such as the addition of Section 337 providing for favorable taxation of "twelve-month" complete liquidations,/52/ the enactment of the 1954 Code did not fundamentally change the federal income taxation of tax-free reorganizations as stated in the 1939 Code./53/

The enactment of the 1954 Code made the following changes to the 1939 Code:

1. In "B" reorganizations, it was now possible for the acquiring corporation to have controlled the target corporation immediately prior to the acquisition./54/

2. The "boot relaxation" rule of Section 368(a)(2)(B) applicable to "C" reorganizations was enacted. In reorganizations involving the acquisition by one corporation of substantially all the properties of another corporation in exchange "solely" for voting stock, it was now permissible for the acquiring corporation to issue a limited amount of cash and other boot./55/

3. The 1954 Code modified the definition of "a party to a reorganization" to include not only the acquiring corporation but also, in specified circumstances, a subsidiary of such corporation./56/

4. The 1954 Code clarified the nonrecognition rules to require recognition of gain realized when a shareholder or security of the target corporation as a result of the exchanges incident to a reorganization: received securities but did not surrender securities; or received an excess principal amount of securities, i.e., received securities having a principal or par value greater than the principal or par value of the securities surrendered./57/

Although there have been a host of major changes in the federal income taxation of corporations and their shareholders since 1971, there have been surprisingly few significant changes in either the statutory definitions of the five types of tax-free acquisitive reorganizations which are the subject of this Study or in the applicable operative provisions. Most of the changes made between 1971 and the enactment of the Tax Reform Act of 1986 (TRA of 1986) have addressed specific problems faced by the Internal Revenue Service in administering these statutes and in attempting to prevent well-advised taxpayers from abusing the statutory provisions./58/

The TRA of 1986 made a number of major changes in the federal income taxation of both individual and corporate taxpayers./59/ The TRA of 1986 repealed the long-term capital gain deduction for individual taxpayers and the use of the alternative tax rate of 28 percent for corporate taxpayers beginning in calendar year 1988./60/ The TRA of 1986 generally provides a maximum marginal federal income tax rate for most individual taxpayers of 28 percent and a maximum marginal federal income tax rate for corporations of 34 percent in calendar year 1988 and beyond./61/

In spite of its scope and complexity, the TRA of 1986 made relatively few changes in the definitional and operative provisions of the 1954 Code which were applicable to tax-free acquisitive reorganizations./62/ Except for the changes made as a result of the repeal of the corporate level nonrecognition provisions based on the <u>General Utilities</u> doctrine, the definitional and operative provisions of the 1986 and 1954 Codes are essentially the same.

Many of the changes made by the Tax Reform Act of 1986 will have very significant indirect effects on planning and structuring acquisitive transactions as taxable transactions or as some type of carryover basis transaction (i.e., the purchase of corporate stock or a tax-free acquisitive reorganization) in the future./63/ Many commentators feel that the repeal of the 1954 Code corporate level nonrecognition provisions for complete liquidations and Section 338 transactions (i.e., purchases of stock treated as the purchase of the underlying assets)/64/ which were based on the General Utilities doctrine may have the ironic effect of leaving the tax law for acquisitions in a state of more complexity, confusion, and uncertainty from both a tax policy and technical perspective than was the case prior to the enactment of the TRA of 1986./65/ The changes in tax rates suggest that structuring an acquisition as some type of tax-free reorganization in order to achieve deferred recognition of realized gain at the target corporation shareholder or security holder level will generally be less advantageous than under the 1954 Code because the lower tax rates reduce the present value of the tax savings from the deferred recognition. The repeal of the General Utilities doctrine/66/ significantly increases the costs of taxable acquisitions for C corporations/67/ and has generally made taxable acquisitions (including Section 338 transactions) less advantageous than carryover basis acquisitions on a present value basis./68/ In addition, the imposition of the new corporate alternative minimum tax provisions, which were added by the TRA of 1986, may be triggered by either the recognized gains or the financial accounting income resulting from liquidating sales or exchanges./69/

An extremely important issue for this Study is the fact that the repeal of the General Utilities doctrine and the elimination of favorable taxation of long-term capital gains for both corporate and individual taxpayers was not accompanied by substantive changes in the tax-free reorganization provisions, and certainly not the far-reaching comprehensive tax reform provisions contained in the Act./70/ The 1986 Code continues the categorical distinctions between taxable and tax-free acquisitive transactions contained in the 1954 Code. Thus the tax law for acquisitive transactions continues to elevate form over substance and remains segmented into a set of potentially conflicting tax laws and tax consequences for transactions structured as "complete liquidations," "tax-free incorporations," "corporate divisions," or "tax-free reorganizations."/71/

The repeal of the General Utilities doctrine has done little to resolve a number of basic tax policy issues which virtually all commentators agree must be resolved in order for significant progress toward comprehensive tax reform to be made in the acquisitive transactions area of the tax law. The tax law under the 1986 Code still contains a hypertechnical statute and regulations which attempt to distinguish the tax consequences of acquisitions of assets, acquisitions of stock, and the many transactions invented by creative tax planners to avoid the effects of the repeal of the General Utilities doctrine which have similarities to both asset and stock acquisitions./72/

The 1986 Code provides no mechanism by which a purchasing corporation can acquire the appreciated assets of a target corporation, take a stepped-up basis and also achieve only a single shareholder level tax as was possible under the complete liquidation provisions and Section 338 elective provisions of the 1954 Code./73/ Stated differently, the 1986 Code implements the Congressional objective of not allowing an acquiring corporation to obtain a stepped-up basis in the target's assets unless the target corporation recognizes all gain realized upon the transfer of appreciated assets./74/

Complete liquidations governed by Section 336 and acquisitions of stock treated as the acquisition of the underlying assets under Section 338 will cause the target corporation to recognize all realized gain at both the corporate and shareholder levels./75/ Acquisitions structured as some type of tax-free reorganization under the 1986 Code are taxed in much the same manner as under the 1954 Code: the acquiring corporation takes a carryover basis in the target's assets, the shareholders and security holders of the target corporation take substituted basis in the acquiring corporation stock and securities received, and the target corporation will generally recognize no gain under Section 361.

Continuation of the categorical distinctions between complete liquidations, Section 338 transactions, and tax-free reorganizations and the continuation of the system of transactional electivity under the 1954 Code will force tax planners to explicitly consider the present value of the tax saving from the basis step-up and the present value of the immediate tax liability at the target corporation and target shareholder level./76/ The repeal of preferential tax rates for long-term capital gains suggests the liquidation-reincorporation doctrine will generally be a less important tax planning issue in the future./77/ However, Section 337(d) of the 1986 Code and the Committee Reports accompanying the TRA of 1986 state that neither the tax-free reorganization provisions nor the consolidated return regulations are to be used to circumvent the repeal of the General Utilities doctrine./78/ Section 337(d) empowers the Treasury Department to prescribe regulations to carry out the purpose of Sections 336, 337, and 338 of the 1986 Code, i.e., to make certain that the target corporation cannot use the tax-free reorganization or the consolidated return provisions to circumvent the intent of Congress in repealing the General Utilities doctrine.

The Revenue Act of 1987/79/ made a number of changes in the taxation of corporations and shareholders./80/ The changes which are most relevant to this Study are those which help one to assess the tax policy issues for acquisitive transactions, those which illustrate that Congress can and will use the federal income tax laws to frustrate taxpayer attempts to avoid the impact of the repeal of the General Utilities doctrine,/81/ and that Congress can and will use the federal income tax laws to penalize takeover-related tactics which have received much adverse attention both by the public and by Congress./82/

The repeal of the _General Utilities_ doctrine and the speed with which tax planners devised creative new methods, or revived older methods, of attempting to take appreciated assets out of one corporation and place them in another corporation at a minimum tax cost demonstrates to many commentators the fact that the tax law has not yet adequately addressed some fundamental tax policy issues for acquisitive transactions such as whether the sale of corporate stock should be treated as the sale of the underlying assets.

Although the Revenue Act of 1987 has eliminated the various mirror subsidiary techniques,/83/ the issue is relevant to this Study because it demonstrates the need for comprehensive, rather than piece-meal, tax reform for acquisitive transactions. The success of the mirror subsidiary technique depended on a highly technical interpretation of the interaction between the 1986 Code's complete liquidation provisions and the consolidated tax return regulations. The Revenue Act of 1987 indicates that Congress will utilize the federal tax laws applicable to acquisitive transactions to prevent or penalize transactions and tactics which are deemed not to be in the public's interest./84/

The Revenue Act of 1987 also added Section 5881 which imposes a new nondeductible 50 percent excise tax on gains realized as a result of receiving "greenmail" payments from a corporation under certain circumstances. The excise tax is imposed whether or not the gain is recognized. Thus the excise tax could be imposed in a transaction otherwise qualifying as a tax-free exchange of stock. Section 5881 is generally effective for greenmail payments received after December 22, 1987./85/

Historical Development of the Judicial Doctrines

In commenting on the role of the judicial doctrines in the tax-free acquisitive reorganization area of the law, Posin has observed:

> Paralleling, or perhaps in counterpoint to, the statutory development described above, there has been a rich development of judicial law on the subject of reorganizations. Indeed, in places the judicial gloss is so heavy that the statute is invisible. It is remarkable and of great theoretical interest that in a subject so exhaustively covered by the statute the case law should play such a critical role.
>
> The judicial doctrines developed from the interplay between the early cases and the early statutory provisions. The early cases . . . presented simple refinancing reorganizations, for which the income tax statute at the time was unprepared. The inconsistent results of the early cases provoked a statutory response, which, with its ambiguities and lacunae, stimulated the planning of more complex transactions and the growth of more elaborate judicial doctrines. Some of these doctrines were in turn adopted by later statutory amendments or by regulations. Others simply held sway in their own right as interpretations of the statute./86/

The continuity of interest doctrine was created in

Courtland Speciality Co. v. Comm./87/ The continuity of interest doctrine is concerned with the type of consideration utilized by the acquiring corporation. Courtland Speciality is widely cited as standing for the proposition that a "reorganization" is fundamentally different from a "sale" and the difference lies in the continuing relationship of the transferor corporation and its shareholders to the assets transferred to the acquiring corporation./88/ Courtland Speciality is also widely cited as limiting tax-free reorganization treatment to those transactions in which the majority of the consideration received by the shareholders of the target corporation is an equity interest in the acquiring corporation./89/

In Courtland Speciality, the Second Circuit had to decide whether the acquisition of substantially all of the properties of a target corporation (Courtland) in exchange for cash and short-term promissory notes (all of which were payable within fourteen months of the date of the transaction) issued by the acquiring corporation (Deyo) constituted a sale of the target's assets or a reorganiation as defined in Section 203(h)(1) of the Revenue Act of 1926. The court found that the target corporation had transferred substantially all of its properties to the acquiring corporation as required by Section 203(h)(1)(A) of the Revenue Act of 1926. The court held that the transaction did not constitute a reorganization due to the absence of any stock consideration.

The present language of Regs. 1.368-1(b) and 1.368-1(c) reflects the following frequently quoted statements of the court:

1. Reorganization, merger, and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more.

2. While the term [reorganization] includes financial readjustments in ways other than by judicial sale, it does not properly embrace mere purchases by one company of the assets of another.

3. A sale of assets of one corporation to another for cash without the retention of any interest of the seller in the purchaser is quite outside the objects of the merger and consolidation statutes.

4. In defining "reorganization," section 203 of the Revenue Act [of 1926] gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms./90/

5. Furthermore the Courtland Company cannot come within the exception to the general rule that gains realized from exchanges of property represent taxable income unless section 203(e) and section 203(e)(1) apply. Under those clauses, even if a transfer to Deyo was an exchange in pursuance of a "plan of reorganization," the property received by Courtland had to include some "stock or securities" (Section 203(e)), or the exemption could not be had. As

no stock was issued against the transfer, the conditions for exemption were not fulfilled unless the notes, all payable within fourteen months of the date of the transfer, and all unsecured, can be considered "securities" under section 203(e). Inasmuch as a transfer made entirely for cash would not be enough, it cannot be supposed that anything so near to cash as these notes payable in so short a time and doubtless readily marketable would meet the legislative requirements.

6. The very reason that section 203(e) requires that some of the property received in exchange should be "stock or securities " is to deprive a mere sale for cash of the benefits of an exemption and to require an amalgamation of the existing interests. There can be no justice or propriety in taxing one corporation who transfers its properties for cash and in relieving another that takes part of its pay in short-term notes. The situation might be different had the "securities," though not in stock, created such obligations as to give creditors or others some assured participation in the properties of the transferee corporation. The word "securities" was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form./91/

In 1933, the Supreme Court decided _Pinellas Ice & Cold Storage Co. v. Comm_./92/ which did much to reinforce the continuity of interest doctrine created in _Courtland_. _Pinellas_ involved many of the same issues as did _Courtland_: whether the acquisition of substantially all of the properties of the target corporation, Pinellas Ice & Cold Storage Company, in exchange for cash of $400,000 and short-term notes of $1,000,000 issued by the acquiring corporation, all of which were well secured by assets of the acquiring corporation and were payable within four months of the purported reorganization, constituted a sale of assets to the acquiring corporation or a tax-free reorganization as defined in Section 203(h)(1) of the Revenue Act of 1926. Most commentators agree that by specifically referring to the Courtland decision, the Pinellas decision caused the continuity of interest doctrine to become a part of the federal income tax law for acquisitive reorganizations./93/

Because the target corporation did in fact transfer all of its tangible and intangible assets to the acquiring corporation, the court held that it had transferred "substantially all of its properties" as required by Section 203(h)(1)(A) of the Revenue Act of 1926. The court, however, refused to characterize the transaction as a "reorganization" with the result that the target corporation had to immediately recognize all gains realized upon the transfer of assets in exchange for the cash and short-term notes received from the acquiring corporation.

The Supreme Court noted that the language of the contract between the acquiring and target corporations referred to the acquiring corporation as the "purchaser" and the target corporation as the "vendor" and spoke of the "sale" and "purchase" of all of the tangible and intangible assets of the target corporation./94/ The court held that the transaction amounted to a sale of the target corporation's property for money and did not involve an exchange of property for securities within the true meaning of the statute. The court found that the short-term notes issued by the acquiring corporation were mere evidence of the obligation of the acquiring corporation to pay the purchase price and therefore should be regarded as the equivalent of cash./95/

The Supreme Court stated:

> It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short-term notes, (all payable within four months), when another who makes a like sale and receives cash would certainly be taxed. We can discover no good basis in reason for the contrary view and its acceptance would make evasion of taxation very easy. In substance the petitioner sold for the equivalent of cash: the gain must be recognized./96/
>
> But the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes. This general view is adopted and well sustained in <u>Courtland Speciality v. Comm</u>. It harmonizes with the underlying purpose of the provision in respect of exemptions and gives effect to all of the words employed./97/

The continuity of business enterprise doctrine is concerned with what the acquiring corporation does with the assets acquired from the target./98/ Most commentators agree the continuity of business enterprise doctrine was created in Courtland Speciality while others note its modern version was created in Becher v. Comm./99/

There is no question that the Supreme Court's decision in Gregory v. Helvering/100/ created the business purpose doctrine. In denying reorganization status to a transactions that would be described as an attempted spin-off under the 1986 Code, Gregory v. Helvering reinforced the notion that tax-free reorganizations involve a continuity of the business affairs of the target corporation. In Gregory v. Helvering, the court stated:

> When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of neither . . ."/101/

The continuity of business enterprise doctrine and the business purpose doctrine created in Gregory v. Helvering are very closely related. In many judicial decisions, the continuity of business enterprise doctrine is often discussed as a subset of the business purpose doctrine. Faber notes the "courts have often been unclear whether they were discussing the continuity of business or [the] business purpose doctrine."/102/

Many of the judicial decisions which shaped the continuity of interest doctrine involved liquidation-reincorporation transactions. In many of the cases, the government either implicitly or explicitly conceded that the continuity of business enterprise requirement was satisfied in attempting to recharacterize the liquidation of the old corporation followed by the reincorporation of its assets in a new corporation controlled by substantially the same shareholders who controlled the old corporation as a nondivisive "D" reorganization. The government sought reorganization treatment in order to force the "new" corporation to take a carryover basis, rather than a stepped-up basis, in the assets of the old corporation, or in order to characterize some of the gain recognized by the shareholders as dividend income, rather than long-term capital gain. The taxpayers involved often argued the continuity of interest requirement was not satisfied in order to prevent undesired reorganization treatment.

In other cases, the government did not want to characterize the transactions as a reorganization in order to prevent the carryover of the tax attributes (most often net operating losses) of the target corporation to the acquiring corporation and thus had to argue that the continuity of business enterprise doctrine was not satisfied./103/ In still other cases, the taxpayers contended that the continuity of business enterprise requirement was satisfied in order for the transaction to be treated as a reorganization./104/

Of the three judicial doctrines created for tax-free reorganizations, the business purpose doctrine is the broadest because it applies to virtually all federal taxation issues/105/ and to tax-free reorganizations./106/ Holzman states:

> One cannot plan, or evaluate, a corporate reorganization without a working knowledge of the Gregory case. There is no more important decision in the realm of tax-free reorganizations; it is to be doubted whether there is a more important case in the entire field of Federal income tax planning./107/

Gregory v. Helvering is frequently cited as standing for the proposition that in order to be recognized for federal income tax purposes, transactions must have some purpose other than merely avoiding taxes./108/ In spite of the taxpayer's rather obvious attempt at tax avoidance, the Board of Tax Appeals, the Second Circuit, and the Supreme Court all agreed that transactions literally complied with the definition of a tax-free reorganization contained in Section 112(g)(1)(D) of the Revenue Act of 1924./109/ The Board of Tax Appeals found that the transactions constituted a valid reorganization:

> A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial con-

> sideration. The general legislative plan apparently was to recognize the corporate entity and, in view of such recognition, to specify when the gains and losses would be recognized and upon what basis they should be measured. We may not destroy the effectiveness this statutory language by denying recognition to the corporation and thus preventing consideration of its transactions./110/

Both the Second Circuit and the Supreme Court held that although the transactions literally complied with the statutory definition of a tax-free reorganization, neither sound tax policy nor the intent of Congress would be served by allowing the taxpayer the desired tax-free reorganization treatment. Both courts held that because the tax-free reorganization provisions presupposed a continuation of corporate business under altered corporate form, the transactions did not constitute a tax-free reorganization because the newly formed controlled corporation existed only so long as necessary to pass appreciated property to the taxpayer.

The Second Circuit's opinion stated:

> . . . the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephermeral incident, egregious to its prosecution./111/

The business purpose requirement contained in the current regulations reflects the language and intent of the Supreme Court's decision. The Supreme Court stated:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether

to avoid them, by means which the law permits, cannot be doubted.

But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having <u>no business or corporate purpose</u>--a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform; no other function. When that limited function had been exercised, it immediately was put to death. (emphasis added).

In these circumstances, the facts speak for themselves, and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose./112/

Appendix B

Recent Empirical Research

In testimony before the Senate Finance Committee on the issues of leveraged buyouts and other corporate restructuring transactions in 1989, Graetz stated:

> There is apparently little evidence that mergers and acquisitions have been predominantly motivated by tax reasons. Deregulation of the financial services industries, for example, seems to have played a more significant role, and nontax economic considerations may well dominate. More over, other social and economic issues, such as dramatically increased corporate risks, potentially may have greater import./1/

Testimony given in the October 1983 hearings on the Preliminary Staff Proposals and in the September 1985 hearings on the final acquisition proposals indicates there is much anecdotal evidence, but very little empirical or "scientific" evidence, about the role the federal income laws play in merger and acquisition decisions. No direct economic evidence was presented on the acquisition proposals in the 1983 Congressional hearings on the Preliminary Staff Proposals. Two economists, Donald Kiefer, a public finance specialist in the Economics Division of the Congressional Research Service, Library of Congress, and Alan Auerbach, a Professor of Economics at the University of Pennsylvania, testified in the 1985 Congressional hearings on the final acquisition proposals.

In the 1985 hearings, Ronald Pearlman, Assistant Secretary for Tax Policy, United States Department of the Treasury, testified that more empirical research was needed before Congress could intelligently and responsibly evaluate the final acquisition proposals. Pearlman's testimony implied that more empirical research would result in some definitive "answers" about the economic consequences of enacting the acquisition proposals. Pearlman's statements directly contradicted the testimony of Kiefer and Auerbach. Pearlman also testified that Congress should not allow valid legal and technical interests in improving the tax statutes and making the tax law more workable to overshadow the very significant potential economic effects of changing the tax laws in the manner suggested by the Subchapter C Revision Act./2/

Commentators have characterized Pearlman's 1985 testimony as a smoke-screen because the Treasury Department does not routinely subject comprehensive tax reform proposals (e.g., Treasury I) to empirical analysis even if such analysis is possible. Several commentators observe that Congress will never enact the acquisition proposals, or any other major tax reform legislation, if it waits until definitive and generally accepted "answers" about the economic consequences of the proposed legislation are forthcoming from economists and other empirical researchers. The 1989 debate over whether Congress should reinstate lower tax rates for long-term capital gains vividly demonstrates this point. In commenting on the Treasury's testimony on the acquisition proposals contained in the Act in 1985, DeArment states:

> Treasury also had a statement in their testimony that seemed to me the most incredible thing I've read. It stated that this project [the Act] ought not to move forward too quickly because there hadn't been any economic analysis done of its far-reaching implications. In a court of equity, Treasury does not come forward with clean hands on that, having laid Tax Reform I and II [Treasury I and II] with their admission of having done no economic analysis and not being capable of doing it. In this particular case, we had some economists that we solicited come forward, very able economists indeed, and they said their analysis was somewhat hampered in that to do a proper analysis, one had to have access to confidential Treasury return information. At any rate, Treasury thinks we ought to wait on this project until we have tax reform done [enactment or nonenactment of proposals in Treasury I and II] which is a death sentence indeed./3/

Both Kiefer and Auerbach testified about the general absence of empirical evidence on merger and acquisition transactions and explained the difficulties of attempting to predict the economic effects of sweeping changes in the tax law, such as those suggested in the acquisition proposals, with any degree of accuracy. Based on his study of probable economic effects of the changes proposed in the Subchapter C Revision Act, Kiefer concluded that enactment of the suggested changes would do little to eliminate various nonneutralities which result from the structural aspects of corporate tax law. Recognizing the existence and consequences of such nonneutralities is an important tax policy issue because they limit the extent to which changes in the provisions governing acquisition transactions can make the law more economically efficient and implement other objectives of comprehensive tax reform./4/ Kiefer's research indicates that the enactment of the Subchapter C Revision Act would have a relatively limited effect on the overall level of corporate acquisitions in the economy because (1) many, if not most, acquisitive transactions occur primarily for nontax reasons and (2) the proposals would not affect some of the most important influences of the tax laws which may encourage acquisitive transactions. Kiefer suggested that enactment of the acquisition proposals might slightly reduce the number of acquisitive transactions motivated largely by the carryover of tax-benefits and those intended to take advantage of the nonrecognition provisions of the 1954 Code codifying the General Utilities doctrine. Kiefer observed that firms in the extractive and insurance industries as well as smaller businesses would be most affected by the repeal of General Utilities because these firms typically hold appreciated assets./5/

In testimony on the final acquisition proposals, Kiefer hedged his conclusions about the economic consequences of enacting the acquisition proposals by stating that economic conclusions about possible changes in the tax laws must come largely from "examining the nature of the tax policies themselves and what anecdotal evidence is available from specific merger and acquisition transactions" rather than from empirical research./6/ Auerbach testified that a tremendous amount of work had been done on the acquisition proposals by professionals trained as lawyers and accountants who studied and evaluated them primarily from a legalistic and workability perspective. Auerbach testified:

> . . . there is very, very little scientific evidence on this subject. There is a lot of information about particularly offensive or large mergers that catch the public eye; and there is a lot of anecdotal evidence that one can gain by talking to different people; but in terms of scientific evidence of the efforts of current tax policy or actual mergers as opposed to the hypothetical incentives to merger, there is really quite a paucity of evidence./7/

Testimony before Congress on the acquisition proposals supports the proposition that the overall structure of the federal tax laws has a more significant influence on acquisitive transactions than the specific provisions governing acquisitive transactions. Both Kiefer and Auerbach stressed the difficulties in measuring the influence of the tax law on mergers and acquisitions. Auerbach testified that the acquisition proposals should be evaluated in view of the present nonneutralities in the tax system rather than from the viewpoint of a brand new tax system./8/

Although some commentators suggest the provisions of the Internal Revenue Codes of 1954 and 1986 have played a disproportionate role in merger and acquisition decisions, there is certainly no consensus on this point and several indications that the tax law does not play a disproportionate role. There is also no consensus to the following rather important question: Can an acquisitive transaction that is not otherwise economically justified become the preferred form of economic activity because of the tax laws?/9/ A review of the empirical research addressing the effect of the federal income tax laws on merger and acquisition activity for large publicly-held corporations has led one prominent financial economist to assert that while there may be relatively little money to be made from the tax-related aspects of acquisitive transactions, there may be much money to be lost from incomplete or incorrect tax planning. Thus, for these corporations at least, tax considerations may be a defensive, rather than an offensive, aspect of acquisition activity./10/

A recent empirical paper by Palepu/11/ is interesting because he developed various logit probability functions/12/ which used independent (predictor) variables deduced from the following six hypotheses suggested in the academic finance literature and the business press to explain corporate takeovers:

1. Inefficient management hypothesis: Firms with inefficient managers are likely targets. The market will replace those managers who fail to maximize the market value of the firm's stock.

2. Growth-resource mismatch hypothesis: Firms with a mismatch between their growth and the financial resources at their disposal are likely targets.

3. Industry disturbance hypothesis: Firms in an industry subject to economic disturbances such as changes in technology, industry structure, and regulatory environment are likely acquisition targets.

4. Size hypothesis: The likelihood of acquisition decreases with the size of the firm.

5. Market-to-book hypothesis: Firms whose market values are low compared to their book values are likely acquisition targets.

6. Price-earnings hypothesis: Firms with low price-earnings ratios are likely acquisition targets./13/

Palepu's paper appears to be one of the most comprehensive empirical papers published to date. Conclusions relevant to this Study are:

1. Investing in the potential target firms identified by the various models does not yield statistically significant excess returns. Thus the ability of the various statistical models to predict takeover targets is not superior to that of the stock market itself.

2. Because Palepu's models used the most plausible explanations or hypotheses for corporate acquisitions to deduce the various independent variables, and alternative combinations of these independent variables, and has presumably corrected the major methodological problems inherent in previous models, its rather low predictive ability strongly suggests that the researchers have yet to formulate a comprehensive explanation for acquisitive transactions, including the role of the federal income tax provisions./14/ The lack of such an explanation makes determination of sound federal income tax policy and the assessment of proposals for changes in specific statutory provisions for acquisitive transactions more difficult.

Breen, a staff economist in the Bureau of Economics of the Federal Trade Commission, recently reviewed virtually all of the theoretical and academic literature on the so-called tax incentive hypothesis for mergers and acquisitions under the 1954 Code./15/ The tax incentive hypothesis argues that the provisions of the Code exert a significant influence on both corporate decisions to participate in an acquisitive transaction and on the legal form of the transaction./16/ Breen's comprehensive review of the academic and professional literature focused on the following four aspects of the 1954 Code most frequently cited in the literature and in Congressional hearings as providing the principal tax incentives for mergers and acquisitions:

1. The opportunity to carryover net operating losses and unused tax credits from the target to the acquiring corporation.

2. The opportunity for the acquiring corporation to step-up the tax basis of assets acquired from the target corporation.

3. The incentive provided by the lower income tax rates on long-term capital gains than on dividends to retain earnings and use the earnings to acquire other firms.

4. The opportunity for an acquiring corporation to deduct interest payments incurred on acquisition-related indebtedness./17/

Breen's observations which are most relevant to this Study include the following:

1. Although the 1954 Code offered the four tax incentives listed above "it is not sufficient that a reading of the tax code indicates the availability of a tax benefit; it is also necessary to take into account (a) any restrictions or limitations that could nullify the use of the tax benefit, and (b) whether the same tax benefit could be realized at less cost by means that do not involve a merger."/18/

2. The ability to actually realize a tax gain from acquisitive transactions is often less than a reading of the Code would suggest. For example, an acquisitive transaction could not be structured under the 1954 Code to achieve both a carryover of the target's tax attributes and a stepped up basis for the target's assets./19/

3. There is no question that aggregate merger activity increased during the 1980s as compared to the 1970s. The recent merger activity has been characterized by mergers of very large corporations and by a number of hostile takeovers and novel defensive strategies (e.g., the Pac-Man defense). However, a review of the changes made to the Code by the Installment Sales Revision Act of 1980, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984, and the Tax Reform Act of 1986, "does not reveal a pro-merger pattern or large-scale transaction bias" that would explain the drastic changes in merger activity in the 1980s./20/

   Breen states:

   In order to conclude that tax considerations played an important role in explaining these changes, one would need to find corresponding changes in the tax code or its application that would be expected to provide additional stimulus to merger activities. One would also need to find that tax code changes were particularly favorable to large-scale transactions./21/

4. In order to support the tax-incentive hypothesis, one would have to demonstrate that, on balance, the <u>net</u> effect of the statutory provisions, including limitations and restrictions on the use of tax benefits and the realization of the tax benefit by a nonacquisitive means, caused corpo-

rations to merge.

Breen states:

> Not surprisingly there is only weak evidence indicating a systematic relationship between any one potential tax benefit, taken in isolation, and merger decisions. Relatively few studies have recognized the importance of calculating the 'net' impact of all the tax provisions taken together, none have actually done this. . . .Further empirical research could reveal that tax considerations played an important role in explaining the recent increase in merger activity. In the meantime, however, a review of recent changes in the tax code [including the Tax Reform Act of 1986] does not suggest that those changes would have substantially increased merger incentives. (emphasis added)/22/

Based on his review of the academic and professional literature, Breen concluded that there is no clear-cut empirical evidence about the extent to which the 1954 Code created incentives for mergers and acquisitions. Breen concludes:

> A considerable amount has been written about the tax treatment of mergers and acquisitions and the tax incentive to merge. To the extent evidence is offered in support of the positions taken, it is largely anecdotal in nature. Relatively few studies have attempted to isolate the tax effect on mergers in a systematic manner. . . . the evidence is very limited and when read in the best light is somewhat inconclusive./23/
>
> While there is no shortage of anecdotal evidence, there are relatively few systematic empirical studies of the effects of tax provisions on mergers. These studies are on the whole inconclusive or, at best, weakly supportive of the tax-incentive hypothesis. What this implies however, is not so much that the tax provisions are unimportant, but rather that further research is necessary to determine their effect.

> In the existing empirical literature, support for the tax incentive hypothesis ranges from weak to none with respect to the carryover of net operating losses and unused tax credits. The hypothesis is weakly supported with respect to the potential to step-up assets. Apart from an ambiguous opinion survey, there is no empirical support of the hypothesized effect of the different tax treatment of capital gains and dividends. Studies are consistent with the argument that merger decisions are sensitive to tax-code provisions pertaining to the deductibility of interest expenses on acquisition-related indebtedness. There is some support for the hypothesis that both the deferral of capital gains taxes and the tax subsidy to debt financing provide incentives on how to structure mergers./24/

The wave of megamergers in the United States in the 1980s has resulted in a vast amount of empirical, legal, and policy oriented research on the effect of mergers and acquisitions./25/ As a general rule, Congressmen do not appear to be impressed by academic or empirical studies, particularly those which demonstrate a loss of tax revenue./26/ Some empirical and much policy-oriented research supported the major themes of the TRA of 1986 (e.g., broadening the tax base, imposing lower marginal tax rates, and generally attempting to make the tax law less economically inefficient). Recent economic research, however, indicates that the TRA of 1986 is likely to decrease economic growth in the United States because it will reduce the ratio of capital to labor, will cause investment to be allocated from industrial investment to personal residential housing, and is likely to have other undesirable economic consequences./27/ Given the frequent and sometimes radical disparities between theoretical predictions and real-world results, it is understandable that members of Congress are not easily persuaded by views of individual economists or other researchers./28/

In conclusion, the inability of researchers to determine the role of federal income taxes in acquisitive transactions and to demonstrate that the tax laws have or have not played a disproportionate role in motivating such transactions strongly suggests that the findings of empirical research cannot be used to support or oppose the proposition that enactment of the acquisition proposals would materially improve the federal income tax law.

Endnotes--Chapter I

1/The federal government's role in regulating corporate takeovers includes the use of the federal antitrust laws, the use of the federal securities laws including the laws governing the functioning of the national securities exchanges, as well as the federal income tax laws. See, e.g., Briggs and Calkins, "Antitrust 1986-1987: power and access (Part I)," XXXII Antitrust Bull. 275 (1987); Easterbrook and Fischel, "Corporate Control Transactions," 91 Yale L.J. 698 (1982); and Hovenkamp, "Antitrust Policy after Chicago," 82 Mich. L. Rev. 213 (1985).

Some respected commentators have urged the federal government to take a much more active role in regulating corporate takeovers, particularly hostile takeovers financed by junk bonds in which large parts of the acquired corporation are often sold to provide funds to service the large acquisition indebtedness. Drucker notes that many of the resource allocation and public policy implications of mergers of large publicly-held corporations are unknown. Drucker also notes that increased regulation is necessary because the typical corporate raider is primarily interested in completing deals instead of making the acquired corporation operate more efficiently. See Drucker, The Frontiers of Management (E. P. Dutton, 1986).

Drucker observes that the shareholders of the acquired corporation will often not approve a takeover unless they receive cash or securities (which they immediately sell) from either the acquiring corporation or from a white knight. The shareholders' actions suggest to Drucker that the shareholders of the acquired corporation know that takeover bids are usually disadvantageous to the acquired corporation. Id., at 244.

See also Lipton, "Corporate Governance In The Age of Finance Corporatism," 136 U. Pa. L. Rev. 1 (1987) and Metz, "Promoter of the Poison Pill Prescribes Stronger Remedy," Wall St. J. (December 1, 1988) at C1.

Lipton, the attorney who popularized the use of the poison pill as a defense against hostile corporate takeovers, now argues that federal government should use its legislative authority to regulate the current wave of abusive and highly leveraged (and sometimes hostile) corporate takeovers occurring in the United States. Lipton argues that the combination of overleveraged corporate takeovers and the takeover frenzy of the 1980s were significant factors leading to the stock market crash of October 17, 1987.

2/See, e.g., Myers, "Will Mergers Help or Hurt in Long Run?" Wall St. J. (May 2, 1987) at 1. Myers argues that the large amount of debt created in acquisitions of publicly-held corporations may be beneficial because it will force the corporation to reduce unnecessary costs and to operate more efficiently. However, even friendly corporate acquisitions often result in staggering costs in terms of dollars and human costs such as layoffs, job relocations, and reduction in employee morale.

3/See, e.g., Kristol, "A Cure for Takeovers' Social Ills," Wall St. J. (May 13, 1987) at 14. Kristol argues rather persuasively that the type of corporate takeovers which have occurred in the 1980s in the United States, particularly hostile takeovers, raise a number of serious, complex, ambiguous, and controversial public policy issues. Kristol asserts that these issues have not received adequate attention given their important consequences to the U.S. economy and the fact that a corporation is a sociological institution as well as an aggregation of economic assets. Certain arguments advanced by Kristol are supported by the literature. See, e.g., Scharstein, "The Disciplinary Role of Takeovers," LV Rev. Econ. Stud. 185 (1988) (arguing that the threat of a hostile takeover is one of the most effective means to force a congruence of goals between management and shareholders) and Frahan, "Corporate Raiders: Head'em Off At Value Gap," 88 Harv. Bus. Rev. 63 (1988) (arguing that in the current environment, managers who do not maximize stock values will not remain managers of publicly-held corporations for very long).

Members of Congress are concerned that tax-exempt pension funds and other nonprofit groups are investing their assets in leveraged buyouts and other rather risky transactions which may not be consistent with their tax-exempt status or with the assumption that they are operated for the exclusive benefit of the plan participants. See Regan, "Pension Funds: New Power, New Responsibility," Wall St. J. (November 2, 1987) at 27 (noting that pension funds own about 50 percent of the stock of companies listed in the Standard and Poors 500) and "House Panel to Study Role of Some Funds in Mergers," Wall St. J. (November 15, 1988) at A6.

4/See, e.g., Werhane, "Two Ethical Issues in Mergers and Acquisitions," 7 J. Bus. Ethics 41 (1988). Werharne notes that the rights of employees (who generally are not consulted but are often directly affected by mergers and acquisitions) and the responsibility of shareholders in mergers and acquisition have not been adequately considered from an ethical perspective. See generally Helyar, "In the Merger Mania Of Interstate Banking, Style and Ego Are Key," Wall St. J. (December 18, 1986) at 1 (suggesting that the desires of top executives are given much more consideration in mergers and acquisitions than are the desires of the employees).

5/See generally Adams and Brock, The Bigness Complex (Pantheon Books, 1986); Bagley, Beyond the Conglomerates (AMACOM, 1975); Bandow, "Are Hostile Takeovers Good for the Economy?" 63 Bus. & Soc'y Rev. 45 (1987); Block, Inside Investment Banking (Dow Jones-Irwin, 1986); Buchanan, "Budgetary Bias in Post-Keynesian Politics: The Erosion and Potential Replacement of Fiscal Norms," in Buchanan, Rowley and Tollison (eds.), Deficits (Basil Blackwell, 1987); Brooks, The Takeover Game (E. P. Dutton, 1987); Collins and Bey, "The Master Limited Partnership: An Alternative to the Corporation," 15 Fin. Mgmt. 5 (1986); Davidson, Megamergers (Ballinger Pub. Co., 1985); DeAngelo and DeAngelo, "Management Buyouts of Publicly Traded Corporations," 43 Fin. Analy. J. 38 (1987); Diamond, Leveraged Buyouts (Dow Jones-Irwin, 1985); Feldstein (ed.), The Effects of Taxation on Capital Accumulation (University of Chicago Press, 1987); Kindleberger and Audretsch (eds.), The Multinational Corporation in the 1980s (MIT Press, 1983); Kinter, Primer On The Law of Mergers (The Macmillian Co., 1973); Lee, "Deficits, Political Myopia, and the Asymmetric Dynamics of Taxing and Spending," in Buchanan, Rowley, and Tollison (eds.), Deficits; Lynch, Financial Performance of Conglomerates (Graduate School of Bus. Adm., Harvard University, 1971); Meek, Woodworth and Dyer, Managing by the Numbers (Addison-Wesley Publishing Co., 1988); Rhodes, Power, Empire Building, and Mergers (Lexington Books, 1983); Rowley, "The Legacy of Keynes: From the General Theory to Generalized Budget Deficits," in Buchanan, Rowley, and Tollison (eds.), Deficits; Sauerhaft, The Merger Game (Thomas Y. Crowell Co., 1971); Sobel, The Rise and Fall of the Conglomerate Kings (Stein and Day, 1984); Sprull, Conglomerates and the Evolution of Capitalism (SIU Press, 1982); Steiner, Mergers: Motives, Effects, Policies (University of Michigan Press, 1975); Stigler, The Intellectual and the Market Place (Harvard University Press, 1984); Waterman, The Renewal Factor (Bantam Books, 1987); and Winslow, Conglomerates Unlimited (Indiana University Press, 1973).

6/See, e.g., Prokesch and Powell, "Do Mergers Really Work?," Bus. Wk. (June 3, 1985) at 88; Toy, Ehrlick and Crock, "The Raiders," Bus. Wk. (March 4, 1985) at 80; Jonas, Crock, Ehrlick and Norman, "How the Tax Code Is

Feeding Merger Mania," Bus. Wk. (May 27, 1985) at 62; Drucker, "Corporate Takeovers--What Is To Be Done?" 82 Pub. Interest 3 (1986); Carney, "Takeover Tussles: The Courts' Tug-of-War With Corporate Boards," Bus. & Soc'y Rev. (Summer 1985) at 64; Marinaccio, "Forcing Corporate Raiders to Walk the Plank," Bus. & Soc'y Rev. (Spring 1985) at 25; and Morrissey, "Defensive Tactics in Tender Offers--Does Anything Go?" 53 Tenn. L. Rev. 103 (1985). An account of the 1982 attempted merger between Bendix Corporation and Martin Marieta Corporation is contained in Hartz, Merger (William Morrow and Company, 1985).

7/The most recent summary of the empirical research on this topic is Breen, The Potential For Tax Gains As A Merger Motive (Bureau of Economics, Federal Trade Commission, 1987). Other recent academic research into the economic, financial, and behavioral consequences of the current wave of mergers and acquisitions will be discussed in Chapter IV of this Study.

8/See, e.g., Clark and Malabre, "Takeover Trend Helps Push Corporate Debt And Defaults Upward," Wall St. J. (March 15, 1988) at 1; Grant, "Corporate Finance, 'Leveraged to the Hilt' Will History Repeat Itself," Wall St. J. (October 25, 1988) at A22; and Forstmann, "Corporate Finance, 'Leveraged to the Hilt' Violating Our Rules of Prudence," Wall St. J. (October 25, 1988) at A22.

For a recent empirical study of whether the growth of debt levels of nonfinancial corporations in the United States constitutes a threat to their financial stability, see Bernanke and Campbell, "Is There a Corporate Debt Crisis?" in Brainard and Perry (eds.), Brookings Papers on Economic Activity I (The Brookings Institution, 1988) at 83. After making various comparisons of the debt to equity ratios (using estimated market values of debt and equity) for the period 1969 through 1986, Bernanke and Campbell conclude that corporate financial conditions, as reflected in this one measure of solvency, have remained fairly stable. Bernanke and Campbell did find some deterioration in some of the standard measures of corporate liquidity such as the ratio of interest expense to cash flow and interest expense to current assets. Contrary to the concerns expressed in the business press and Congress about the growing use of junk bonds in mergers and acquisitions and in leveraged buyouts, Bernanke and Campbell (at 124) found:

> However, there is little evidence that the emergence of junk bonds has changed the meaning of standard financial ratios. First, junk bonds make up only a small part of total corporate debt; although con-

stituting about 20 percent of corporate bonds outstanding in 1986, junk bonds account for well under 10 percent of nonfinancial corporate debt, including bank loans and short-term debt. Second, junk bond issues have increased largely at the expense of bank loans to corporations. As such, they are part of the trend toward 'securitization' of traditionally intermediated instruments. Because junk bonds tend to be held by mutual funds, insurance companies, and other institutions, it seems likely that their expanded use has increased rather than reduced the difficulty of avoiding bankruptcy through negotiation. Finally, far from being an innovation, low-grade bonds were used extensively in the 1920s.

9/In the past several years, the volume, size, and often hostile nature of leveraged buyout (LBO) transactions and the increasing power of LBO specialist firms, such as Kohlberg Kravis Roberts & Co. (KKR) has done much to make both the general public and members of Congress much more aware of the costs and benefits of corporate takeovers, particularly those which are heavily financed by debt and in some cases subinvestment grade (junk) bonds. Several LBO transactions have not worked out as planned. See, e.g., Phillips, "The LBO Where Everything Went Wrong," Bus. Wk. (May 9, 1988) at 47 (describing the financial problems of Revco D.S. Inc. which was acquired in a $1.3 billion management-led LBO).

See generally "The LBO Binge," Wall St. J. (October 27, 1988) at A1 (many chief executive officers expressed concern that the massive amount of debt which typically occurs in a LBO may leave the resulting corporation without funds necessary for research and development which is often a critical component of being globally competitive).

The business press reports that in the first six months of 1988, LBOs accounted for $21.1 billion of the $98.1 billion in merger and acquisition transactions. Melloan argues that much of the substitution of debt for equity in LBOs and other highly leveraged transactions is mainly a device to avoid taxation (due to the deductibility of interest but not dividend payments). See Melloan, "An LBO for the Teacher--Good Practice or Bad?" Wall St. J. (November 22, 1988) at A15.

LBOs have been described in the following manner:

> A leveraged buyout (LBO) is the acquisition of an established business using borrowed funds, secured by the assets or cash flow of the business itself. High

> leverage in an LBO facilitates the extraction of large amounts of cash from the target by its shareholders. In effect, leverage permits the seller in a target to dispose of high-value unleveraged shares, thus maximizing cash withdrawn from the target.

See Lynch, Baldasaro and Siegel, "Strategies to maximize benefits in leveraged buyouts after TRA '86," 41 Tax'n for Acct. 304 (1988).

Bryan's research indicates that in addition to the tax savings from the deductibility of the large amount of debt typically incurred in an LBO, the historical bias of the tax law in favor of nondividend distributions (which have historically been taxed at favorable long-term capital gain rates or as a return of capital) rather than at the ordinary income rates for dividends is the primary income tax incentive for LBOs. See Bryan, "Leveraged Buyouts and Tax Policy," 65 N.C.L. Rev. 1039 (1987).

The largest LBO to date was the much publicized hostile acquisition of RJR Nabisco by KKR for approximately $25 billion. This transaction and reactions to it are discussed in Helyar and Burrough, "How Underdog KKR Won RJR Nabisco," Wall St. J. (December 2, 1988) at A1; Alsop and Freedman, "RJR Takeover Could Hurt Marketers and Consumers," Wall St. J. (December 2, 1988) at A4; Wessel, "Buy-outs Bring Confusion, and Maybe Money, for IRS," Wall St. J. (December 2, 1988) at A4; Smith, Birnbaum and Ricks, "Will Others Follow as RJR Tames Megadeal Frontier," Wall St. J. (December 2, 1988) at C1; and Dobrzynski, "The Lessons Of The RJR Free-For-All," Bus. Wk. (December 19, 1988) at 30.

10/Zolt argues that the substitution of debt for equity is one of the "self-help" means by which corporations seek to integrate and reduce the effect of the two-tier corporate tax scheme in the United States. See Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium," 66 N.C.L. Rev. 839 (1988). See also Farrell, "Learning to Live with Leverage," Bus. Wk. (November 7, 1988) at 138 and Laderman, "What Does Equity Financing Really Cost?" Bus. Wk. (November 7, 1988) at 146.

Bierman feels that because Congress can never properly distinguish corporate debt and equity and because both debt and equity are valid forms of financing a corporation, Congress should phase out the deductibility of interest expense. Bierman believes a principal benefit of the elimination of the tax subsidy to the use of debt would be that mergers and acquisitions (and leveraged buyouts) would be evaluated on more of a pure economic basis and less on the basis of how to utilize the tax savings due to the deductibility of interest. See Bierman, "Debt, Stock, and Junk Bonds," 41 Tax Notes 1237 (December 12, 1988).

The literature suggests that a principal concern with eliminating the deductibility of interest expense in the United States is that it would increase the cost of capital for corporations which would discourage corporate investment in plant and equipment and other longer term projects and lead to various macroeconomic problems. See, e.g., Summers, "Comment and Discussion" on Bernanke and Campbell, "Is There a Corporate Debt Crisis?" in Brainard and Perry (eds.), Brookings Papers on Economic Activity I (The Brookings Institution, 1988) at 130-136.

The possibility that changes in the deductibility of interest expense will cause significant adverse stock market reactions is pointed to by proponents of mergers and acquisitions and opponents of limiting the deductibility of interest expense for federal income tax purposes See, e.g., Yardeni, "The M&A Tax Scare Rattling the Markets," Wall St. J. (October 28, 1987) at 26 (discussing the possibility that the Ways and Means Committee of the House of Representatives might recommend limiting the deductibility of interest expense of acquisition indebtedness to $5 million per year and the dampening effect enactment of such limitations would have on mergers and acquisitions, including leveraged buyouts).

Most commentators do not agree that possible limitations on the deductibility of interest expense incurred on acquisition indebtedness was a major contributor to the stock market crash in October 19, 1987. Most commentators feel that the stock market was overvalued and a decline in prices was inevitable. See, e.g., Clark, "Some Thoughts on the Stock Market Bubble on '87," Wall St. J. (December 12, 1987) at 22 (noting that no specific event occurred on October 19, 1987, or in the immediately preceding days to explain why the Dow Jones Industrial Average dropped over 508 points in one day) and Kristol, "Look at 1962, Not 1929," Wall St. J. (October 28, 1987) at 26. Other commentators feel that monetary policy as implemented by the Federal Reserve Board was responsible for the stock market crash. See, e.g., Kemp, "Monetary Policy Caused the Crash--Central Banks Must Coordinate," Wall St. J. (October 22, 1987) at 34; Canto and Laffer, "Monetary Policy Caused the Crash--Not Tight Enough," Wall St. J. (October 22, 1987) at 34; and Roberts, "Monetary Policy

Caused the Crash--Too Tight Already," Wall St. J. (October 22, 1987) at 34.

11/Alan Greenspan, the Chairman of the Federal Reserve Board, recently testified before the Senate Banking Committee that limiting the deduction for interest incurred on debt issued in leveraged buyout transactions might be appropriate given the increasing use of corporate debt by many large publicly-held corporations. See Gray, "Greenspan Suggests that Congress Examine Incentives for Debt Financing," 41 Tax Notes 582 (November 7, 1988).

Pete Stark (D-California), a member of the House Ways and Means Committee, recently stated that Congress should move quickly to eliminate or limit the interest deduction and other tax benefits for leveraged buyout transactions. Stark stated:

> It's not good for the nation to have the Fortune 500 go to the monopolistic Fortune 10. If the Administration's antitrust division were doing its job, it wouldn't have let Nabisco [RJR Nabisco] be bought by KKR [Kohlberg Kravis Roberts & Co., an LBO specialist firm], which already owns large parts of the food delivery chain."

"Congressional Roundup," 41 Tax Notes 1354 (December 19, 1988).

Reports on the leveraged buyout of RJR Nabisco by KKR estimate that the annual tax savings to RJR Nabisco due to the deductibility of interest expense will amount to about $1 billion. See Vamos, Ticer and Norman, "For KKR, Here Comes The Grunt Work," Bus. Wk. (December 19, 1987) at 28.

The concern expressed over the vast amount of debt used in the acquisition of RJR Nabisco by KKR is merely the most recent indication that Congress is becoming increasingly concerned with highly leveraged debt-financed corporate takeovers. Possible legislative responses include disallowing the deductibility of some portion of the interest expense on acquisition indebtedness (particularly junk bonds) in order to reduce the subsidy given to leveraged acquisitions, attempting to more clearly distinguish between debt and equity for federal income tax purposes (many commentators argue that junk bonds have more equity than debt characteristics), allowing the deductibility of dividend payments to reduce the biases in the current law in favor of debt financing, and restoring a lower tax rate for recognized long-term capital gains (to encourage investors to invest in stocks rather than bonds).

These issues are discussed in Birnbaum, "Capitol Hill Panels To Keep Eye Out For Buy-Out Taxes," Wall St. J. (December 19, 1988) at A3; Hale, "How to Lower the Leverage Boom," Wall St. J. (November 29, 1988) at A20; "Junk Politics," Wall St. J. (December 1, 1988) at A14 (editorial arguing that curtailing the deductibility of interest expense makes no sense and will grant foreign investors a major tax advantage over domestic investors); and "Takeovers: Congress Should Butt Out," Bus. Wk. (December 19, 1988) at 59 (editorial arguing that eliminating or curtailing the deductibility of interest expense would only serve to favor foreign investors over domestic investors).

12/See generally Canellos, "The Overleveraged Acquisition," 39 Tax Law. 91 (1985). A detailed discussion of how leveraged buyouts and other highly leveraged transactions were structured under the 1954 Code is contained at 91-109.

13/See generally Berton, "Investors, Beware the Secrets Lurking In Buy-Out Firm's Financial Reports," Wall St. J. (November 21, 1988) at A8 (quoting partners at Big Eight accounting firms who state that accounting and financial reporting standards have not caught up with the unique issues and problems presented by leveraged buyout transactions) and Pensler, "Accounting Rules Favor Foreign Bidders," Wall St. J. (March 24, 1988) at 28.

Abraham Briloff argues that generally accepted accounting procedures and financial reporting practices have historically done very little to accurately report the results of business combinations (and particularly the recent "going private" transactions of large publicly held corporations) and to help shareholders determine the likely consequences of the combination. See Briloff, "Accounting Practices and the Merger Movement," 45 Notre Dame Law. 604 (1970) and Briloff, "Cannibalizing the Transcendent Margin: Reflections on Conglomeration, LBOs, Recapitalizations and Other Manifestations of Corporate Mania," 44 Fin. Analy. J. 74 (1988).

14/See, e.g., Levin and Bowen, "Taxable and Tax-Free Two-Step Acquistions and Minority Squeeze-Outs," 33 Tax L. Rev. 425 (1978), Beghe, "The American Law Institute Subchapter C Study: Acquisitions and Distributions," 33 Tax Law. 743 (1980); Ginsburg, "Taxing Corporate Acquisitions," 38 Tax L. Rev. 171 (1983); Pugh, "Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and

Substance," 35 Tax L. Rev. 359 (1980); Jacobs, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (1980); Milner, "Boot Under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction, but Too Far," 62 TAXES 507 (1984); Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions and Dispositions: Substance and Process," 22 San Diego L. Rev. 17 (1985); Thompson and Ginsburg, "A Comparison Of The Merger And Acquisition Proposals In The Senate Finance Committee's Draft Bill," 22 San Diego L. Rev. 157 (1985); Rosenberg, "The Reluctant Bride: Tax Treatment of Costs of Resisting Corporate Takeovers," 13 J. Corp. Tax'n 114 (1986); Palmieri," Fiduciary Responsibilities Under ERISA in Corporate Takeovers," 13 J. Corp. Tax'n 127 (1986); Willens, "Taxes and Takeovers," 162 J. Acct. 86 (1986); Hoffman, "The AT&T Divesture: Tax Planning for Tax-Free Spin-Offs Which Involve Ineligible Businesses," 64 TAXES 619 (1986); Lang, "Dividends Essentially Equivalent to Redemptions: The Taxation of Bootstrap Stock Acquisitions," 41 Tax L. Rev. 309 (1986); Bowen, "Defenses Against Takeovers--Selected Tax Problems," 64 TAXES 835 (1986); Golub, "The NOL: Yesterday, Today, and Tomorrow," 45 Inst. on Fed. Tax'n (1987) at 2-1; Schimel and Innamorato, "New restrictions on use of net operating losses when there is a change in corporate ownership," 15 Tax'n for Law. 362 (1987); and Moore and Schuck, "Tax Aspects of Defensive Strategies to Corporate Takeovers," 69 J. Tax'n 212 (1988).

Some of the recent acquisitive transactions and novel federal income tax issues and problems are discussed in the "Innovative Transactions" section of TAXES. See, e.g., Walter and Strasen, "Rockefeller Center Properties, Inc.," 64 TAXES 13 (1986); Walter and Strasen, "Sonat Inc.'s Purchase of Debentures of the Costal Corporation," 64 TAXES 77 (1986); Walter and Strasen, "Fox Television Stations, Inc. Increasing Rate Exchangeable Guaranteed Preferred Stock," 64 TAXES 234 (1986); Walter and Strasen, "General Motors Class E and Class H Common Stock," 64 TAXES 365 (1986); Walter and Strasen, "Sale of Union Carbide's Consumer Products Division," 64 TAXES 421 (1986); Walter and Strasen, "Eli Lilly Acquisition of Hybritech--Contingent Payment Units," 64 TAXES 488 (1986); Walter and Strasen, "Public Leverage Buyouts: Anderson, Clayton & Co. and FMC Corporation," 64 TAXES 548 (1986); Walter and Strasen, "Acquisition of Beatrice Companies, Inc.," 64 TAXES 628 (1986); Walter and Strasen, "The Americus Trust 'Prime' and 'Score' Units," 65 TAXES 221 (1987); and Walter and Strasen, "Contingent and Adjustable Stock In a Public Context," 65 TAXES 439 (1987).

15/Although the term "tax-free" reorganization is often used to describe an acquisitive transaction structured to satisfy the requirements of the Internal Revenue Code, the term "tax-deferred" is much more descriptive. A "tax-free" reorganization is a transaction which satisfies the requirements of the Internal Revenue Code, the accompanying regulations, and the various judicial doctrines discussed in this Study. Such transactions are eligible for the federal income tax treatment prescribed in the operative sections of the Internal Revenue Code and the regulations.

16/Chapter III of this Study will discuss many of these problems in some detail. See generally Krane "Current Problems in Acquisitive Reorganizations," 51 TAXES 737 (1973); Faber, "The Use and Misuse of the Plan of Reorganization Concept," 38 Tax L. Rev. 515 (1983); and Faber, "The Search for Consistency in Corporate Acquisitions," 13 J. Corp. Tax'n 187 (1986).

17/See, e.g., Report of the Chairman of the Subcomm. on Telecommunications, Consumer Protection, and Finance of the Comm. on Energy and Commerce (U.S. House of Representatives), Corporate Takeovers: Public Policy Implications For The Economy And Corporate Governance, 99th Cong., 2nd Sess. (Comm. Print 99-QQ 1986). This 119 page report addresses two key questions which have frequently been raised during the wave of megamergers and hostile takeovers during the 1980s: (1) What is the impact of corporate takeovers on economic growth and financial stability? and (2) What is the impact of corporate takeovers on shareholders and corporate governance? Id., at III. The report reflects the conclusion of the vast literature on the various aspects of mergers and acquisitions that there is no consensus either among the experts or the diverse participants in takeover contests on the overall issue of whether, on balance, the wave of corporate takeovers in the 1980s in the United States has been beneficial or detrimental to the economy. Id., at IV.

18/See Economic Report of the President (1985), Chapter 2, "The Federal Budget and the Economy," and Chapter 6, "The Market for Corporate Control." Chapter 6 suggests that, as a general rule, mergers and acquisitions have had beneficial effects on the economy of the United States. Chapter 6, however, expresses a concern that certain acquisitive transactions represent actions undertaken primarily for perceived tax benefits rather than actions undertaken based on rational business judgments. See discussion at 200-201.

Many commentators feel that Chapter 6 of the 1985 Economic Report of the President is a misguided and naive free-market manifesto detailing all of the economic and social benefits of an unimpeded market for corporate control. See, e.g., Davidson, Megamergers. Davidson has concluded there are serious defects in the present market for corporate control, particularly the paucity of information generally made available to the shareholders of the target corporation. Id., at 334. Davidson has concluded that because the United States antitrust laws only deal indirectly with the issues of corporate power and size, and that under the Reagan Administration the antitrust laws have only rarely been used to prevent mergers of the largest publicly-held corporations, i.e., megamergers, the antitrust laws have become largely irrelevant to today's top level corporate executives. Id., at 358. See also Adler, "Hands-Off Antitrust Policy Likely to End, Whoever Wins the Presidential Election," Wall St. J. (October 24, 1988) at B1 and Dwyer, "The Reagan Revolution In Antitrust Won't Fade Away," Bus. Wk. (April 18, 1988) at 29.

Finally, Davidson feels that "Congress appears to have lost confidence in its ability to legislate. It has become preoccupied with economic growth, but doubtful of its ability to intervene in helpful ways. As a consequence, we are apt to see more megamergers." Id., at 334.

For a defense of the unimpeded market for corporate control, see Jensen, "A Helping Hand for Entrenched Managers," Wall St. J. (November 4, 1987) at 30. In arguing against changes in the notification requirement under the present federal securities laws (which requires that purchasers disclose their holdings of stock and intentions within ten days of acquiring five percent or more of a company's shares in a 13d report), Jensen states:

> The restructuring of corporate America (including divestitures, spinoffs and "going private" transactions) that is being brought about by the takeover market is streamlining many of the largest and most complex corporations that are simply too large, too complicated and too unfocused to be efficient. Restructuring is bringing top-level managers closer to employees, customers and shareholders. We must not strangle these productive forces. Shareholders and the financial institutions that are the intermediaries should rise up in outrage at what Sen. Proxmire and entrenched managers are proposing to do to them.

For additional defenses of an unimpeded market for corporate control, see "Take A Knife To The Budget Deficit . . . Instead Of To Dealmaking," Bus. Wk. (November 9, 1987) at 164. This editorial argues that although the federal government should use its power "to curb the worse abuses of the speculators," the government must be careful not to "throttle an important part of the corporate renewal process." Bus. Wk. argues: "Takeovers are an integral part of the restructuring movement sweeping the American economy--restructuring that is sorely needed if U.S. companies are to compete successfully in global markets."

See also Bergsma, "Do-It-Yourself Takeover Curbs," Wall St. J. (February 12, 1988) at 10 (arguing that a corporation's best defense against a hostile takeover is to make sound investment and operating decisions rather than adopting poison pills, adopting "shark repellant" amendments to its corporate charter, etc.) and Dobrzynski, "A New Strain Of Merger Mania," Bus. Wk. (March 21, 1988) at 122 (arguing that many corporate executives feel that takeovers are a structural part of the corporate landscape which will continue as long as there are companies which can be made more efficient).

19/See, e.g., Weinstein, "Acquisitions Made To Evade Or Avoid Income Tax--Section 269," Mertens Tax Highlights (Nov. 1987) at 2. Weinstein concludes that Section 269 (entitled Acquisitions made to evade or avoid income tax) has been remarkably ineffective in preventing tax avoidance in merger and acquisition transactions. This ineffectiveness is due primarily to the subjective intent approach of Section 269. See also Soligna, "A Survey of Legal Factors Helpful in Establishing the Principal Purpose Motivation Requirements of Section 269," 64 TAXES 302 (1986).

20/See generally Bradford, Untangling the Income Tax (Harvard University Press, 1986).

21/See Staff of Senate Comm. on Finance, 98th Cong., 1st. Sess., The Reform and Simplification of the Income Taxation of Corporations (S. Prt. 98-95 1983); Staff of Joint Comm. on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions: Hearings Before Subcomm. on Oversight and the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means (Joint Comm. Print 1985); Staff of Joint Comm. on Taxation, Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (And S. 420, S. 476, S. 632): Hearings Before Subcomm. on Taxation and Debt Management of the Comm. on Finance

(Joint Comm. Print 1985); Staff of Joint Comm. on Taxation, Special Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations: Hearings Before Subcomm. on Select Revenue Measures of the Comm. on Ways and Means (Joint Comm. Print 1985); and Staff of Joint Comm. on Taxation, 98th Cong., 1st Sess., Tax Reform Proposals: Corporate Taxation (Joint Comm. Print 1985).

22/See Staff of the Senate Comm. on Finance, 98th Cong., 1st. Sess., The Subchapter C Revision Act of 1985 (S. Prt. 99-47 1985).

23/See The American Institute of Certified Public Accountants, Statement of Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises (1979).

24/See, e.g., Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1984) and Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1985).

25/See, e.g., Testimony of F. J. O'Connell (on behalf of the American Institute of Certified Public Accountants), "The Proposals to Revise Subchapter C of the Internal Revenue Code" contained in Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance, 99th Cong., 1st Sess. (S. Hrg. No. 99-506 1985).

26/Unless otherwise indicated, all statutory references in this Study are to the Internal Revenue Code of 1986 as amended to date, and to the currently applicable regulations issued by the United States Department of the Treasury. Where appropriate, differences in the language of the Internal Revenue Codes of 1954 and 1986 (as enacted by the Tax Reform Act of 1986, P. L. No. 99-514, 100 Stat. 2985) will be explicitly stated and discussed. As discussed infra, the Tax Reform Act of 1986 made only minor changes in the operative sections of the 1954 Code. As a result, the definitional sections and overall philosophy of the 1986 Code applicable to tax-free acquisitive reorganizations are virtually unchanged from those contained in the 1954 Code.

27/Bittker and Eustice, the leading academic commentators on Subchapter C of the Code, note that the reorganization provisions are extraordinarily complex, even for the Internal Revenue Code. See Bittker and Eustice, Federal

<u>Income Taxation of Corporations and Shareholders</u> (Warren, Gorham & Lamont, Inc., 1979) at 14-6 and 14-7. The fact that an attempted "B" reorganization between International Telephone and Telegraph Corporation (ITT) and Hartford Fire Insurance Company (HFIC) was subject to litigation for over ten years and ultimately resulted in the payment of over ten million dollars by ITT to the Internal Revenue Service to satisfy the additional tax liabilities of the shareholders of HFIC, the target corporation, because the acquisition was ultimately not treated as a "B" reorganization demonstrates the complexity of the tax law even for very sophisticated and well-advised taxpayers. The ITT-HFIC transaction is discussed in McMahon, "Defining the 'Acquisition' in B Reorganizations Through the Step Transaction Doctrine," 67 <u>Iowa L. Rev</u>. 31 (1981) and Thompson, "Qualifying as a 'B' Reorganization; The <u>ITT-Hartford</u> Cases; Alternatives to Use of a 'B'," 39 <u>Inst. on Fed. Tax'n</u> (1981).

28/<u>Roy G. Andersen et. al.</u>, TC Memo 1964-98 (1964), <u>aff'd</u> 341 F. 2d 584 (9th Cir. 1965). One of the major criticisms of the current law is that it is effectively elective at least for well-financed and well-advised taxpayers who can engaged sophisticated tax advisers to fit transactions into or out of the "mandatory" definitional sections of the Code. In discussing the provisions of Sec. 338 under the 1954 Code, Martin Ginsburg has stated:

> Explicitly in section 338(a)(1) and (h)(8) and (9), and implicitly hither and yon, Congress reconfirmed what every tax lawyer has known from graduation day. Subchapter C is an <u>elective taxing regime</u>, and it works best when the elections are made by checking a box and <u>not by exquisitely tailoring corporate instruments</u>. (emphasis added)

Ginsburg, "Taxing Corporate Acquisitions," 38 <u>Tax L. Rev</u>. 171 (1983) at 199-200.

Proponents of the Subchapter C Revision Act argue that horizontal equity and other important tax policy objectives require that the present system of transactional electivity should be replaced with a system of explicit corporate level electivity for economically similar acquisitive transactions.

29/The current financial accounting and federal income tax requirements (including the changes made in accounting for income taxes by FASB Statement 96) for acquisitive transactions are summarized in Arthur Andersen & Co., <u>Guide to Mergers and Acquisitions</u> (1988). The impact of FASB 96 on business combinations is discussed in Laibstain, "Income Tax Accounting for Business Combinations," LVIII CPA J. 32 (1988) and Read and Bartsch, "How to Account for Acquisitions Under FASB 96," 167 J. Acct. 54 (1989). A detailed discussion of the current federal income tax law applicable to tax-free reorganizations is contained in Bittker and Eustice, Federal Taxation of Corporations and Shareholders (Warren, Gorham & Lamont, Inc., 5th Student Ed., 1987) at 14-1 through 14-239.

30/See Regs. 1.368-1(b).

31/See Regs. 1.368-1(b).

32/One of the principal criticisms of the current law is that although it is very complex and hypertechnical, it does little to properly distinguish transactions which should and should not be granted tax-free treatment based on their economic substance. See, e.g., Roberts, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (1980). Proponents of the Subchapter C Revision Act of 1985 feel it would eliminate the overlaps in the present definitional provisions and generally provide a more coherent and rational taxing regime for acquisitive transactions.

33/The principal underlying assumptions for tax-free acquisitive reorganizations, which were created as judicial doctrines and have long been reflected in the regulations, are the continuity of interest doctrine (Regs. 1.368-1(b) and 1.368-2(a)), continuity of business enterprise doctrine (Regs. 1.368-1(b) and 1.368-1(d)), and the business purpose doctrine (Regs. 1.368-1(b) and 1.368-1(c)). The Subchapter C Revision Act of 1985 would eliminate compliance with these assumptions as a prerequisite for tax-free treatment.

34/A taxable transaction is one in which all gains realized are immediately recognized. Thus if a corporation sells all of its assets to another corporation for cash, the selling corporation would have to immediately recognize all gain realized. If the selling corporation distributed the after-tax proceeds of the sale to its shareholders as a liquidating distribution, the shareholders would also have to immediately recognize all gains realized. The statutory and judicial concepts of a "tax-free reorganization" are intended to distinguish such sales of corporate assets in which all gains realized should be immediately recognized from those transactions which are merely changes in corporate forms in which the deferred recognition of gains realized is permissible. The historical development of the notion of a "tax-free reorganization" is discussed in the Appendix to Chapter III of this Study.

35/Freeman, Tax Strategies For Leveraged Buyouts and Other Corporate Acqusitions (Practising Law Institute, 1985) at 18.

36/Thus an "A" reorganization is the type of transaction described in Sec. 368(a)(1)(A), a "B" reorganization is the type of transaction described in Sec. 368(a)(1)(B), etc.

37/Although the current tax law permits triangular or subsidiary "B" and "C" reorganizations, these types of acquisitive reorganizations are not addressed in this Study. These transactions have tax policy implications which are similar to triangular or subsidiary "A" reorganizations which are addressed in this Study. Detailed discussions of acquisitive transactions structured as triangular transactions are contained in Ferguson and Ginsburg, "Triangular Reorganizations," 28 Tax L. Rev. 159 (1973); Testa, "The 'A,' 'B,' 'C' Matrix of Triangular Reorganizations," 38 Inst. on Fed. Tax'n (1980) at 1-1; Grippo, "Use Of The Tax-Free Triangular Merger For The Acquisition Of Two Corporations With Cross-Ownership," 14 J. Mar. L. Rev. 33 (1980); Cook and Coalson, "The 'Substantially All Of The Properties' Requirement in Triangular Reorganizations--A Current Review," 35 Tax Law. 303 (1981); Schlenger, "Triangular Acquisitions," 40 Inst. on Fed. Tax'n (1982) at 49-1; Lasseinge, "Federal Tax Aspects of Corporate Triangular Reorganizations," Prentice-Hall Tax Ideas (1984) at 25,951 through 25,960; and Willens, "An Analysis of the reverse triangular merger regulations," 17 Tax Adviser 72 (1986).

38/In both the academic and professional tax literature, the acquired corporation is variously referred to as the "acquired" corporation, the "target" corporation, or the "transferor" corporation.

39/In both the academic and professional tax literature, the acquiring corporation is variously referred to as the "acquiring" corporation or the "transferee" corporation.

40/See Regs. 1.368-2(b)(1). The mechanics of effecting a merger under state law and the associated federal income tax issues are discussed in Harper, "How to Merge or Consolidate a Going Business," Prentice-Hall Tax Ideas (1978) at 24,411 through 24,448.

41/<u>See</u> Sec. 368(a)(1)(A). Under present law, the transaction must also satisfy the continuity of interest doctrine to constitute an "A" reorganization. The laws of some states allow cash mergers (sometimes called cash-option mergers) in which the target corporation is merged directly into the acquiring corporation. The acquiring corporation pays cash to the target shareholders for their stock. <u>See, e.g.</u>, Rev. Rul. 69-6, 1969-1 CB 104. Although such a merger may be "statutory," it will not be a tax-free reorganization because it violates the continuity of interest doctrine. The continuity of interest doctrine will be discussed in detail in Chapter III of this Study.

42/<u>See</u> Sec. 368(a)(1)(B) and Regs. 1.368-2(c). A current tax planning issue is whether stock of a corporation which carries "poison pill" rights can be used in a "B" reorganization without violating the solely for voting stock requirement or in a "C" reorganization without constituting boot. Comment and Jarrell have defined "poison pill" rights as follows:

> In general, a poison pill rights issue is a warrant with an exercise price conditional on a merger. The conditional exercise price is set so that the warrant is deep out of the money before a merger and (arbitrarily) deep in the money after any merger. Issued as a dividend by the target firm, it becomes an obligation of the surviving company after the merger. It also has a call provision so that it can be cancelled at the discretion of target management to clear the way for a negotiated takeover.

Comment and Jarrell, "Two-Tier And Negotiated Tender Offers," 19 <u>J. Fin. Econ</u>. 283 (1987) at 284.

Private Letter Ruling 8808081 deals with a situation in which a corporation adopted a shareholder stock right "poison pill" to ward off a hostile takeover. The corporation subsequently issued its stock carrying poison pill rights to the owner of a closely-held corporation. The ruling indicates that such rights are a separate, valuable property the receipt of which results in the realization and recognition of gross income to the owner.

The ruling did not directly address the broader question of whether the use of such stock as consideration in a "B" or "C" reorganization would violate the solely for voting stock language of the Code and Regulations because the poison pill rights are not an inherent part of the stock but represent stock warrants, an asset separate from the stock. <u>See</u> "Tax Report," <u>Wall St. J</u>. (April 6, 1988) at

1. Commentators have noted that if PLR 8808081 is interpreted in this manner, the many publicly-held corporations which have adopted poison pills may be unable to use their stock as consideration in "B" and possibly "C" reorganizations. This issue is discussed in detail in Dionne, "IRS Ruling that Poison Pills Bar Some Tax-Free Reorganizations Stirs Controversy," 39 Tax Notes 679 (May 9, 1988). See also Scott, "The Solely For Voting Stock Requirement: Are Poison Pill Rights Permissible Attributes Of Stock In A 'B' Reorganization?" 41 Tax Law. 151 (1988).

A common tax planning issue in "B" reorganizations is whether the target corporation, which becomes a new controlled subsidiary of the acquiring corporation, can or must join with its new parent corporation in the filing of a consolidated federal income tax return instead of continuing to file its separate federal income tax return. Tax planning issues relating to consolidated returns are discussed in Hyman and Hoffman, "Consolidated Returns: Summary of Tax Considerations in Acquisitions of Common Parent or Subsidiary Member of Affiliated Group," 33 Tax Law. 383 (1980) and Willens, "Consolidated Returns and Affiliated Groups (with a nod to Wall Street)," 161 J. Acct. 60 (1986).

43/See Sec. 368(a)(1)(C) and Regs. 1.368-2(d). "C" reorganizations under the 1986 Code are discussed in Flinn, "C Reorganizations Under The Internal Revenue Code of 1986: Is More Tax Reform Needed?" 35 Oil & Gas Tax Q. 645 (1987).

Sec. 368(a)(2)(G)(i) of the 1954 Code and Sec. 368(a)(2)(G)(i) contain the distribution requirements for "C" reorganizations. Sec. 368(a)(2)(G)(i), as amended by the Tax Reform Act of 1984, generally required the target corporation to distribute the stock and securities received from the acquiring corporation, as well as any property which was not transferred to the acquiring corporation, to its shareholders in order to effect a tax-free "C" reorganization. Thus the target corporation in a stock-for--assets reorganization generally underwent a complete liquidation in order to satisfy the distribution requirements of the Tax Reform Act of 1984. Sec. 368(a)(2)(G)(ii) provided that the Secretary could waive the distribution requirement of Sec. 368(a)(2)(G)(i). Sec. 368(a)(2)(G)(i), as amended by the Tax Reform Act of 1986, makes its clear that the distribution requirement for "C" reorganizations is satisfied if the distribution of the stock and securities received from the acquiring corporation and of the target corporation's property not transferred to the acquiring corporation is made to the creditors, as well as the shareholders, of the target corporation. Under Sec. 368(a)(2)(G), as amended by the Tax Reform Act of 1986, if the target corporation does not transfer appreciated assets to the acquiring corporation, the target corporations's distribution of such assets to its shareholders will generally result in recognition of gain to the target corporation. These issues are discussed in Baldasaro and Hoops, "Tax Act of 1986--Corporate Changes," LVI CPA J. 28 (1986) at 36.

Sec. 368(a)(2)(A) is an overlap provision which provides that if a transaction fits the statutory description of a "C" reorganization and a nondivisive "D" reorganization, the transaction will be treated exclusively as a nondivisive "D" reorganization in order to force it to satisfy the active business and other requirements of Sec. 355. The role of Sec. 355 is discussed in Flinn, "Divisive and nondivisive 'D' reorganizations vs. Sec. 355 transactions," 12 Tax Adviser 388 (1981). An example of how the tax consequences of divisive reorganizations and Sec. 355 transactions differ from acquisitive reorganizations is contained in Hoffman, "The AT&T Divestiture: Tax Planning for Tax-Free Spin Offs Which Involve Ineligible Businesses," 64 TAXES 619 (1986).

Unfortunately the Code does not contain statutory provisions which deal with many of the other potentially overlapping transactions. See generally Sachs, "Subchapter C Overlap Problems," 40 Inst. on Fed. Tax'n (1982) at 48-1.

44/See Secs. 368(a)(1)(A), 368(a)(2)(D) and Regs. 1.368-2(b)(2). In a forward cash triangular merger, the target corporation is merged into a subsidiary of the acquiring corporation, target corporation shareholders receive cash provided by the parent corporation for their target stock, and the acquiring corporation, which is a controlled subsidiary of the parent corporation, remains in existence. See, e.g., Rev. Rul. 79-273, 1979-2 CB 125.

45/See Secs. 368(a)(1)(A), and 368(a)(2)(E) and Regs. 1.368-2(j). In a reverse subsidiary cash merger, a subsidiary of the parent corporation is merged into the target corporation and loses its identity, the parent corporation winds up with control of the stock of the target corporation, and the shareholders of the target corporation receive cash provided by the parent corporation for their target shares. See. e.g., Temp. Regs. 1.338-4T, Q & A 3.

46/The philosophy and operation of the complete liquidation provisions of the 1954 Code are discussed and illustrated in Flinn and Fulks, "Complete Liquidations of S Corporations: New Planning Required Under the Subchapter S Revision Act of 1982-Part II," S Corporations: Tax Choices for Business Planning (Prentice-Hall Loose-Leaf Tax Service, June 1986) at 1319-1345.

47/The complete liquidation and the Sec. 338 provisions of the 1954 Code were based on General Utilities & Operating Co. v. Helvering, 296 U.S. 299 (1935), 16 AFTR 1126, 36-1 USTC 9012. Sec. 338 allows the acquiring corporation to make a statutory election to treat certain purchases of target corporation stock as the purchase of the underlying assets.

The effects of the repeal of the 1954 Code corporate level nonrecognition of gain provisions which codified the General Utilities doctrine are discussed in Willens, "General Utilities is Dead: The TRA of '86 Ends an Era," 162 J. Acct. 102 (1986) and Freeman, "Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsman of the Repeal of General Utilities," 64 TAXES 962 (1986).

48/The Tax Reform Act of 1986 did not repeal the definitional and netting provisions for net capital gain income of individual and corporate taxpayers in order to prevent confusion if Congress decides to restore a lower tax burden on long-term capital gains. See Gardner and Stewart, "Capital Gains and Losses After the Tax Reform Act of 1986," 65 TAXES 125 (1987) and Faber, "Capital Gain v. Dividends in Corporate Transactions: Is The Battle Still Worth Fighting?" 64 TAXES 865 (1986).

49/See Sec. 361(b)(1) of the 1986 Code. Under the 1986 Code, the target corporation recognizes no gain or loss on receipt of stock or securities issued by the acquiring corporation. See Sec. 361(a). If the target corporation receives noncash boot from the acquiring corporation, the target corporation will take a basis in the boot equal to its fair market value because the acquiring corporation will have to recognize gain if it distributed appreciated property to the target in exchange for the target's property. See Sec. 361(b)(2). The target will therefore recognize no gain or loss if such noncash boot is distributed to the target shareholders. If the target corporation undergoes a complete liquidation as part of a tax-free reorganization, e.g., as is normally required in a "C" reorganization, the target will recognize no gain or loss upon a distribution to its shareholders and security holders of any stock or securities issued by the acquiring corporation. See Sec. 361(b)(3). Sec. 361(c) of the 1986 Code requires the target corporation to recognize gain if it distributes its own appreciated property, i.e., property not transferred to the acquiring corporation, to its shareholder in a complete liquidation which is part of the overall tax-free reorganization.

The repeal of the corporate level nonrecognition of gain provisions based on the General Utilities doctrine is seen in Secs. 361(b)(2) and 361(c) of the 1986 Code. These issues are discussed in Brandt and Maloney, "Reorganization instead of liquidation may accomplish same result will much less tax," 34 Tax'n for Acct. 388 (1987).

The business press reports that many mergers and acquisitions were completed prior to January 1, 1987, in order to avoid the effects of the repeal of the General Utilities doctrine and the elimination of lower tax rates for long-term capital gains of individual and corporate taxpayers in the Tax Reform Act of 1986. See Hertzberg and Miller, "Merger Wave Hits Wall Street As Firms Rush to Beat Year-End Tax Changes," Wall St. J. (October 31, 1986) at 13.

50/The current nonrecognition of realized gain is obtained at the cost of the acquiring corporation having to take a carryover basis in assets acquired from the target corporation or a substituted basis in target corporation stock acquired from the former target shareholders. The shareholders of the target corporation must take a substituted basis in the stock or securities received from the acquiring corporation. One of the principal changes suggested by the Subchapter C Revision Act is to partially uncouple the corporate and shareholder level tax consequences of certain acquisitive transactions.

51/As discussed throughout this Study, a major goal of the Subchapter C Revision Act of 1985 was to provide the same tax consequences for functionally and economically equivalent acquisitive transactions irrespective of their classification and treatment under the 1954 Code. The Act thus includes tax-free acquisitive reorganizations, liquidating sales under Section 337, and purchases of target corporation stock treated as an acquisition of assets under the elective provisions of Sec. 338 in the broad definition of "qualified acquisitions." The Act provides the same tax treatment for these transactions and thus eliminates the categorical distinctions found in the 1954 Code.

Because the TRA of 1986 repealed the various provisions which codified the General Utilities doctrine, the 1986 Code reflects one of the Act's fundamental positions that this doctrine must be repealed in order for any meaningful and lasting tax reform of the provisions for acquisitive transactions to be achieved. Under the 1986 Code, all gains realized will be recognized at the corporate level upon a liquidating sale or in-kind liquidating distribution of appreciated assets and upon a purchase of target stock for which a Sec. 338 election is made. The 1986 Code has thus adopted one of the major and perhaps the most controversial changes in corporate taxation proposed by the Act.

52/In a Sec. 338 transaction, the acquiring corporation makes a statutory election to treat the target corporation as if it had undergone a complete liquidation and distributed its assets and liabilities to the acquiring (parent) corporation. In general, the acquiring corporation must pay the resulting federal income taxes (which often effectively reduces the amount of consideration offered for the target corporation). Under the 1954 Code, the General Utilities doctrine operated as it did in complete liquidations under Sec. 337 and prevented the recognition of all gain realized upon the hypothetical liquidating sale and distribution of the target's assets to the acquiring corporation.

Under the 1986 Code, Sec. 338 elections are generally disadvantageous because the present value of the tax savings from a stepped-up basis in the target's assets is generally less than the present value of the immediate tax cost of the election to the acquiring corporation. These issues are discussed in Buchholz, "The Consistency Requirements of Section 338--Inconsistencies and Incongruities," 13 J. Corp. Tax'n 283 (1987); Everett, Clevenger and Bolling," Should a Section 338 Election Be Made for an Acquisition: A Framework for Decision Making," 21 Prac. Acct. 49 (1988); and Kotlarsky, "Stepping Up Basis: The Purchase of Stock or Purchase of Assets," 39 Tax Notes 1101 (May 30, 1988).

53/See Mullaney and Bailine, "Corporate acquisitions after the Tax Reform Act of 1986," 18 Tax Adviser 212 (1987) at 225. A detailed discussion of tax planning for acquisitive transactions under the current law is contained in Brode, Tax Planning For Corporate Acquisitions (Prentice Hall/Rosenfeld Launer Publications, 1988) and Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics Not Being Basic," 14 J. Corp. Tax'n 203

(1987).

54/The receipt of a private letter ruling is commonly viewed as a limited form of insurance or guarantee that if the proposed transaction is carried out substantially as described in the ruling request, the Service will treat the transaction as described in the request. The process of requesting private letter rulings for tax-free reorganizations is discussed in "How to Get a Corporate Reorganization Ruling From the Revenue Service," Prentice-Hall Tax Ideas (1978) at 25,311 through 25,330.

55/See, e.g., Chisholm and Phelan, "Corporate reorganizations: Three main routes may be used to avoid tax on the transaction," 10 Tax'n for Acct. 196 (1973); Lipner, "Six routes to tax-free corporate changes: Each have different requirements," 19 Tax'n for Acct. 19 (1977); Hutchins, "How to structure a tax-deferred corporate acquisition or division as a 'reorganization,'" 25 Tax'n for Acct. 362 (1980); Hutchins, "Tax consequences of reorganizations depend on the particular type selected," 26 Tax'n for Acct. 28 (1981); Adroin, "Selecting the most advantageous type of reorganization in corporate acquisitions," 36 Tax'n for Acct. 114 (1986); Levitan, "Dealing with Liabilities in Reorganizations," 39 Inst. on Fed. Tax'n (1981) at 8-1; and Weinstein, "Some Pitfalls and Planning Opportunities in Corporate Reorganizations," Mertens Tax Highlights (October 1986) at 2-9. Books which discuss both the business and federal income tax aspects of mergers and acquisitions include Kintner, Primer on the Law of Mergers (The Macmillan Company, 1973); McGaffey, Buying, Selling, and Merging Businesses (American Law Institute-American Bar Association, 1979); and Steiner, Mergers: Motives, Effects, Policies.

56/See Regs. 1.368-1(b) and 1.368-1(c).

57/Under the current administrative interpretation, the continuity of interest requirement is satisfied for advanced ruling purposes if the former shareholders of the acquired corporation receive, in the aggregate, stock of the acquiring corporation which is equal in value to at least 50 percent of all the formerly outstanding stock of the acquired corporation. See Sec. 3.02 of Rev. Proc. 77-37, 1977-2 CB 568. Thus, as occurred in May B. Kass, 60 TC 218 (1973), if a majority of the former shareholders of the target corporation receive cash or other consideration which does not constitute a continuing ownership interest in the affairs of the acquired corporation, minority shareholders who received only stock of the acquiring corporation will have to immediately recognize all gain realized because the overall transaction is not a reorganization. Proponents of the Subchapter C Revision Act of 1985 argue that if a former shareholder of the acquired corporation only receives qualifying consideration, no gain should be recognized irrespective of the type of consideration received by any other former shareholders of the acquired corporation and irrespective of the corporate level tax consequences.

58/See American Law Institute, Federal Income Tax Project Subchapter C Tenative Draft No. 1 (1977); American Law Institute, Federal Income Tax Project (1980); and American Law Institute, Federal Income Tax Project Subchapter C--Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Dispositions (1982).

59/See Comm. on Finance, The Reform and Simplification Of The Taxation Of Corporations, 98th Cong., 1st Sess. (S. Prt. 98-95 1983).

60/See Reform of Corporate Taxation: Hearings Before the Comm. on Finance, 98th Cong., 1st Sess. (S. Hrg. 98-556 1983).

61/See Staff Recommendations to Revise Subchapter C: Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance, 99th Cong., 1st Sess. (S. Hrg. 99-506 1985).

62/Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions and Dispositions: Substance and Process" at 37.

63/Subchapter C Revision Act of 1985 at 50. Discussions of the acquisition provisions contained in the Senate Finance Comm. 1983 recommendations are contained in Shaw, "Impact of Proposals on Acquisitions of Closely Held Corporations," 22 San Diego L. Rev. 17 (1985) and Thompson, "A Comparison Of The Merger and Acquisition Provisions of Present Law With The Provisions In The Senate Finance Committee's Draft Bill," 22 San Diego L. Rev. 171 (1985).

64/A "qualified acquisition" under the Act would be defined much more broadly than a "tax-free acquisitive reorganization" under current law. New Sec. 364 would define a qualified acquisition as either a qualified stock acquisition (QSA) or a qualified asset acquisition (QAA). The Act indicates that the five types of tax-free acquisitive reorganizations under current law which were the subject of this Study would constitute either QSAs or QAAs. These transactions would thus remain eligible for deferred recognition of realized gain at both the corporate and shareholder levels without satisfying three long-standing judicial doctrines. The Act would deal with various overlap issues between QSAs and QAAs and, more broadly, between qualified acquisitions and other potentially conflicting transactions such as tax-free incorporations under Sec. 351. See Subchapter C Revision Act of 1985 at 50.

65/Under the Act, the term "control" would be conformed to the definition of control applicable to groups of corporations having the privilege of filing consolidated returns. See Sec. 1504(a)(2) of the 1954 Code.

66/The Subchapter C Revision Act of 1985 would codify the ninety and seventy percent interpretation of the "substantially all of the properties" requirement of Sec. 368(a)(1)(C). These percentage interpretations, and related tax planning issues under the 1986 Code, are discussed in Flinn, "C Reorganizations Under The Internal Revenue Code of 1986: Is More Tax Reform Needed?" Oil & Gas Tax Q. 656 (1987).

67/A discussion of the role of the continuity of interest doctrine under current law is contained in Chapter III of this Study.

68/A discussion of the role of the continuity of business enterprise doctrine under current law is contained in Chapter III of this Study.

69/A discussion of the business purpose doctrine is contained in Chapter III of this Study.

70/See Subchapter C Revision Act of 1985 at 50.

71/As noted in the discussion of the present federal income tax law applicable to all tax-free reorganizations, the transaction must satisfy the statutory definition as well as the judicially developed doctrines in order to constitute a valid tax-free reorganization. Thus the corporate and shareholder tax consequences are linked. Under current law, tax planners are very much concerned with the possibility that one or more of these judicial doctrines could be violated, thus preventing the entire transaction from being taxed as a "reorganization." The Subchapter C Revision Act of 1985 (at 40) states "some uncertainty surrounds the exact parameters of these tests [the judicial doctrines].

Under current law, if the overall transaction is not a "tax-free reorganization" at the corporate level, the operative sections of the Internal Revenue Code discussed previously cannot be applicable. The Code generally provides that all realized gains must be immediately recognized by the corporate and noncorporate parties involved in an acquisitive transaction if it does not constitute a "tax-free reorganization."

The Subchapter C Revision Act of 1985 (at 41) states that this linking of corporate and shareholder level tax consequences "produces a number of anomalous results."

The Act seeks to reduce these problems by eliminating the judicial doctrines (Proposal Two), allowing explicit corporate level electivity of tax consequences (Proposal Three), and separating corporate level and shareholder level tax consequences (Proposal Four).

72/This carryover basis rule means that the acquiring corporation will step into the shoes of the target corporation in terms of the income tax basis of assets acquired, depreciation and investment tax credit recapture potential, etc. As noted, structuring an acquisition as a "tax-free reorganization" under present law is a means of deferring recognition of gain or loss realized at both the corporate and shareholder levels. Under the Act, the related basis rules will continue in operation and will therefore cause the deferred gain or loss to be recognized upon the occurrence of future taxable dispositions as is the case under present law.

73/Sec. 1012 provides a general rule that the tax basis of assets acquired will be their cost unless the Code provides otherwise. Under the Act, the basis of any property received in a qualified asset acquisition is the fair market value of such property on the acquisition date. The basis of stock acquired by an acquiring corporation in a qualifying stock acquisition will be determined under a new Section 1020 to be created by the Act. The basis of stock acquired by an acquiring corporation in a cost basis acquisition will be determined as follows: The target corporation will be deemed to have sold all of its assets for fair market value as of the close of the acquisition date in a transaction in which gain or loss is recognized; then it is treated as a new corporation which purchased all of such assets as of the beginning of the day after the acquisition date. <u>See</u> Subchapter C Revision Act of 1985 at 51 and 52.

74/<u>See</u> Subchapter C Revision Act of 1985 at 52.

75/Id.

76/Id. When the acquiring corporation is a member of an affiliated group, the Act provides that the qualifying consideration is the stock and securities of the common parent of such group and any other member of such group as specified in the regulations.

77/Id. The Act provides that the nonrecognition rule applies to the receipt of securities only to the extent the issue price of any securities received does not exceed the adjusted basis of any securities surrendered.

78/The Act provides that the determination of a dividend effect is to be made by treating the shareholders as having received only qualifying consideration in the exchanges incident to the reorganization and then as being redeemed of all or a portion of such qualifying consideration (to the extent of the nonqualifying consideration received). The Act also provides that for dividend effect determinations, the earnings and profits of both the acquiring and acquired corporations will generally be taken into account. Id., at 53.

79/Id. As is the case under current law, the recognition of gains realized but not immediately recognized is accomplished through the related basis rules. The Act provides a general rule that shareholders and security holders of the target corporation will obtain a substitute basis in any qualifying consideration received and a fair market value basis in any nonqualifying consideration received. The Act uses the term "substitute" basis while the term "substituted" basis is more commonly used under current law. The Act also provides a general rule that the controlling shareholders of the target corporation will obtain an income tax basis in any qualifying consideration received equal to the lesser of a substitute basis or a fair market value basis.

80/See Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1985) at 3. Joseph Pechman, a widely respected economist long associated with The Brookings Institution, agrees with the use of these four general criteria. See Pechman, Federal Tax Policy (The Brookings Institution, 1983) at 5. As discussed in Chapter IV of this Study, a few commentators have criticized the use of such traditional tax policy concepts to evaluate the current tax law and proposed changes in the law. See. e.g., Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic

Alternative," 31 Vill. L. Rev. 1665 (1986).

81/If, as was often the case, the subgoals could apply to more than one major goal, the researcher used his judgment and classified the subgoal under the most appropriate major goal.

Endnotes--Chapter II

1/Traditional public policy research issues and associated methodologies are discussed in Anderson, Public Policy Making (Holt, Rinehart and Winston, 2d Ed., 1979), Bullock, Anderson and Brady, Public Policy in the Eighties (Brookes/Cole Publishing Co., 1983), and Majchrzak, Methods For Policy Research (Sage Publications, 1984).

2/Traditional tax policy research issues and associated methodologies are discussed in Kramer, "Tax Research: Past, Present, and Prognosis." Paper presented at the Accounting Research Convocation held at the University of Alabama (November 2-4, 1984).

3/A concise summary of the various types of tax-free reorganizations and the requirements for nonrecognition of realized gain or loss under the 1986 Code is contained in Knight and Knight, "An Update on Tax-Free Reorganizations," LVIII CPA J. 58 (1988). As discussed throughout this Study, neither the Tax Reform Act of 1986, P. L. 99-154, the Revenue Act of 1987, P. L. 100-203, nor the Technical and Miscellaneous Act of 1988, P. L. 100-647, made any major changes in the definitional or operative provisions governing transactions classified as tax-free acquisitive reorganizations. As discussed in Chapters III and IV of this Study, the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 and other changes made by these recent tax bills appears to have made the eventual enactment of the four proposals for change in the law contained in the Subchapter C Revision Act of 1985 less likely than may have otherwise been the case. See generally Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future," 46 Inst. on Fed. Tax'n (1988) at 37-1.

4/Dye, Policy Analysis (University of Alabama Press, 1976) at 1.

5/Id.

6/Id., at 1 through 21.

7/Anderson, Public Policy Making at 183. Anderson notes that researchers should resist the notion that policy analysis must always involve the manipulation of quantitative or "hard" data through the use of high-powered statistical techniques. Anderson, however, notes that quantitative measurement, explicit theory, and careful, rigorous analysis have not been as frequently employed in the study of public policies as would be either possible or desirable. Id., at 183-184.

A general discussion of the major differences between parametric and nonparametric statistical inference techniques is contained in Siegal, Nonparametric Statistics (McGraw Hill Book Co., 1956). A technical discussion of the type of multivariate statistical techniques currently employed in much of the empirical accounting and tax research is contained in Dunteman, Introduction to Multivariate Analysis (Sage Publications, 1984).

8/See generally Majchrzak, Methods For Policy Research. The possibility that corporations and other groups and individuals demand various theories or research results by "independent" researchers who are on the "cutting edge" of their professions to mask their selfish intentions and justify their actions by appealing to the greater public good has been discussed in both the accounting and economics literature. Watts and Zimmerman, for example, have argued that the demand for prescriptive accounting literature, e.g., literature which advocates certain treatments or policies such as neutral government policies toward mergers and acquisitions based on normative arguments, illustrates that there is a market for excuses. See Watts and Zimmerman, "The Demand and Supply of Accounting Theories: The Market for Excuses," 54 Acct. Rev. 273 (1979) and Watts and Zimmerman, "Towards a Positive Theory of the Determination of Accounting Standards," 53 Acct. Rev. 112 (1978). See generally Stigler, "Do Economists Matter?" 42 S. Econ. J. 347 (1976).

Watts and Zimmerman have illustrated the operation of the demand for excuses as follows:

> Individuals want accounting policy prescriptions for self-interest reasons (e.g., electric utility managers want an accounting standard so they can argue for the use of the required procedure in rate setting). But, in the political process that is a competition for wealth transfer and is characterized by costly information, it isn't optimal to announce publicly that you want the prescription for selfish reasons. The optimal strategy is to argue that the prescription is in the public interest (e.g., maximizes some social welfare concept). Hence, there is a demand for arguments that the desired accounting prescription is in the public interest.

Watts and Zimmerman, Positive Accounting Theory (Prentice-

Hall, 1986) at 339.

As illustrated throughout this Study, the recent megamerger boom in the United States has resulted in a large volume of empirical and policy research on the various public policy issues. There are some indications that the market for excuses may be operating in the merger and acquisition literature. Consider, for example, the 1979 testimony of George Benston before Congress. Benston, an advocate of limited government interference in the market for corporate control, argued that market forces will act to prevent large corporations from acquiring other corporations in order to enlarge corporate size and without regard to the economic desirability of the merger itself. The principal reason is that managers acting in this manner will become subject to displacement by either the Board of Directors of the corporation or by hostile takeovers by another corporation. See Subcomm. on Antitrust, Monopoly, and Business Rights, Comm. on the Judiciary (Part II), U.S. Senate, 96th Cong., 1st Sess. (1979) at 230-231. Benston's views on mergers and acquisitions are contained in Benston, Conglomerate Mergers: Causes, Consequences, and Remedies (American Enterprise Institute, 1980). Because Benston was paid for testifying before Congress and his research has been supported by the American Enterprise Institute, certain commentators have questioned the validity of Benston's testimony.

9/In policy determination studies, the policies themselves are the dependent or response variables and the various factors which resulted in specific policies being enacted or allowed to stay in place are the independent or predictor variables.

10/In policy impact studies, the social, economic, and political consequences of certain policies are the dependent or response variables and the policies themselves are the independent or predictor variables.

11/Majchrzak states: "Activities undertaken in the name of policy research will vary not only with the problem being addressed, but with the style, creativity, and judgment of the researcher." Majchrzak, Methods For Policy Research at 11.

12/Anderson, Public Policy Making at 184.

13/Id., at 182.

14/Majchrzak, Methods For Policy Research at 19.

15/Buckley, Buckley, and Chaing, Research Methodology and Business Decisions (National Association of Accountants, 1976). Buckley et. al. argue there are abundant opportunities for inductive research in accounting and taxation and that the paucity of such research to date can only be explained by an unawareness of the need for or potential usefulness of this type of research. Id., at 22.

16/Id., at 21.

17/Id., at 16 and 22. Policy determination research is conducted in an inductive mode and is directed at these types of questions.

18/Id., at 16 and 23. Policy impact research is conducted in a deductive mode and is directed at these types of questions.

19/Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., The Subchapter C Revision Act of 1985 (S. Prt. 99-47 1985).

20/As will be discussed in Chapter III of this Study, most commentators agree that the essential definitional and operative features of the current statutory provisions applicable to tax-free acquisitive reorganizations were included in the Revenue Act of 1934, 48 Stat. 705. See, e.g., Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations (S. Prt. 98-95 1983) at 3-4.

21/The literature on research methodology suggests a number of advantages of using available data in performing research including the following: (1) helps the researcher to understand the past; (2) helps the researcher to understand social change; (3) helps the researcher to improve knowledge through replication and increased sample size; and (4) helps the researcher to obtain nonreactive measurements on the data sources. See Singleton, Straits, Straits and McAllister, Approaches to Social Research (Oxford University Press, 1988) at 335-338.

22/Explicit consideration of the major goals and related subgoals of comprehensive tax reform in the United States in the tax-free acquisitions area of the federal income tax law was necessary to improve the internal and external validity of the Study. The explicit specification of the four proposals to be investigated and the general and specific criteria used to evaluate them was necessary to establish boundaries on the scope of the Study.

23/For example, although one can certainly determine whether a taxpayer won or lost a specific case, it is often difficult to make a meaningful ordinal judgment, i.e., a ranking, that taxpayer A won or lost his case by a larger margin than did taxpayer B. Similarly, while one can generally determine the presence of each of the factors on which a court based its decision, it is often difficult to make an ordinal judgment as to the relative importance of the various factors which ultimately influenced the court's final decision. Similarly, it is almost impossible to state that a proposed change in the tax law will improve it by some stated percentage.

Doctoral dissertations and other empirical research which employ various multivariate statistical techniques to analyze reported decisions are often limited to building predictive, rather than explanatory, models of past judicial decisions. In such studies, the researcher often states that the major contribution of the study was the identification of the variables which the courts have viewed as being the most important in a certain area of the tax law. Researchers typically limit any implication that building a statistical model having a high level of predictive ability was the primary goal of the study or that the use of the resulting model to accurately predict future judicial decisions represented a major contribution of the study. See, e.g., M. DeCelles, "An Examination of the Factors Affecting the Judicial Assessment of Continuity of Interest in Corporate Reorganizations," (Ph.D. dissertation, The University of Oklahoma, 1983) at 12-13.

24/Equity, economic efficiency, simplicity, and encouragement of specific activities as the major goals of comprehensive tax reform efforts in the United States are well accepted in the tax literature. For a contrary view, see Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative," 31 Vill. L. Rev. 1665 (1986). The subgoals of comprehensive tax reform, i.e., the unique tax policy considerations for tax-free acquisitive transactions, were identified by the researcher from the reported cases and the tax literature. Each of the four proposals for change in the Subchapter C Revision Act of 1985 was evaluated by the major goals and related subgoals.

25/The typical empirical study focuses on theory testing using a deductive approach rather than on theory building using an inductive approach. Many empirical studies start with a given theory and use a relatively large number of observations on the data sources to statistically test a relatively few research questions which are often stated in the form of null and alternative hypotheses and which are logically derived from the theory. See Abdel-khalik and Ajinkya, Empirical Research in Accounting: A Methodological Viewpoint (American Accounting Association, 1979) at 9-28. Recent examples of this type of empirical research include Moore, Steece and Swenson, "An Analysis of the Impact of State Income Tax Rates and Bases on Foreign Investment," LXII Acct. Rev. 671 (1987) and Bowen, Burgstahler and Daley, "The Incremental Information Content of Accrual Verses Cash Flows," LXII Acct. Rev. 723 (1987). In many of the empirical tax studies, the data sources are used to build a descriptive model of past judicial decisions. See, e.g., R. Rolfe, "An Empirical Investigation into the Judicial Classification of Transactions as Sales or Leases for Federal Income Tax Purposes" (Ph.D. Dissertation, The University of Oklahoma, 1983); Robinson, "Tax Court Classification of Activities Not Engaged in For Profit: Some Empirical Evidence," 5 J. Am. Tax'n A. 7 (1983); and Steer, "Obtaining and Preserving Tax-Exempt Status under Section 501(c)(3): Judicially Developed Factors for Detecting the Presence of Substantial Nonexempt Activities," 6 J. Am. Tax'n A. 63 (1985).

26/A detailed discussion of the deductive approach to logically deducing and testing theories is contained in Dubin, Theory Building (The Free Press, 1978). A detailed discussion to problem solving generally is contained in George, Problem Solving (Gerald Duckworth & Co. Ltd., London, 1980). A discussion of the philosophy of empirical research performed by economists is discussed in Johnson, Research Methodology For Economists (Macmillian Pub. Co., 1986). Johnson argues there are three types of research: disciplinary (improves the discipline); subject-matter (multidisciplinary research on a set of practical problems of interest to a set of decision makers); and problem solving (multidisciplinary research directed at solving specific problems). Id., at 12-13. Johnson also argues that the different types of research require different kinds of knowledge and ideologies (positivism, normativism, and pragmatism) as well as different kinds of research approaches. Id., at 30-38.

27/A detailed discussion of standard research designs used in empirical studies to gain efficiency and to rule out various threats to the internal and external validity of the study is included in Kerlinger, Foundations of Behavioral Research (Holt, Rinehart and Winston, 2nd Ed., 1973), Campbell and Stanley, Experimental and Quasi-Experimental Designs for Research (Rand McNally Publishing Co., 1966), and Campbell, Quasi-Experimentation (Houghton Mifflin Co., 1979).

28/An alternative mode of statistical testing is contained in Dansereau, Alutto, and Yammarino, Theory Testing in Organizational Behavior: The Varient Approach (Prentice-Hall, Inc., 1984).

29/Kramer, "Tax Research: Past, Present, and Prognosis."

30/Id., at 15.

31/Id., at 4.

32/Id., at 5. The 1982-1983 Tax Research Methodology Committee of the American Taxation Association has encouraged academic accountants to perform more tax policy research. The principal reasons include: (1) The accounting profession's role in tax policy formulation is much less than it should be. (2) Academic accountants have often allowed economics and the legal profession to "usurp" their rightful role of performing tax policy analysis. See also Crumbley, "Behavioral Implication of Taxation," XLVIII Acct. Rev. 759 (1973). (3) There is a virtually unlimited number of ex ante and ex post policy issues and questions to investigate. See C. Reese, Chairman, "Report of the 1982-1983 American Taxation Association Committee on Tax Research Methodology" (Am. Acct. A., 1983) at 26-31. It appears that academic accountants have become more active in using different types of research methodologies to explore tax issues. See, e.g., Davis and Swenson, "The Role of Experimental Economics in Tax Policy Research," Faculty Working Paper No. 1414 (Bureau of Economic and Business Research, College of Commerce and Business Administration, University of Illinois, November 1987).

33/See, e.g., Magill, Taxable Income (The Ronald Press Co., 1945).

34/Id., at 4. Magill notes that analyzing and evaluating any group of decisions requires careful consideration of the particular state of facts surrounding them.

35/Id., at 16. Magill notes that a complete analysis of the statutes and decisions requires some consideration of the stated and unstated premises on which they are based and of alternative premises.

36/Id., at 6.

37/Id. Magill notes that the Treasury Department's recommendations were followed by Congress in enacting Sections 112 and 113 of the Revenue Act of 1924, 43 Stat.

257.

38/A recent example of such policy oriented tax research conducted by an academic attorney is contained in McMahon, "Reforming Cost Recovery Allowances For Debt Financed Depreciable Property," 29 St. Louis U.L.J. 1029 (1985). In this study, the author uses a logical and conceptual analysis, rather than a statistical analysis, to determine whether the stated objectives of the Economic Recovery Tax Act, Pub. L. No. 97-34, 95 Stat. 172, the Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, 96 Stat. 324, and the Tax Reform Act of 1984, Pub. L. No. 98-368, 98 Stat. 494, in enacting and modifying the Accelerated Cost Recovery System (ACRS) were satisfied. The three stated tax policy objectives investigated are equitable distribution of tax burden, minimizing interference with economic growth, and efficiency. Using a historical analysis and numerical examples demonstrating how the ACRS system actually functions for debt financed property, the author concludes that because the present ACRS system for debt financed property allows cost recovery deductions at a rate more rapid than amortization of the loan used to finance the property, the ACRS provisions did not achieve any of the three stated tax policy objectives. The author recommends that Congress eliminate the demonstrated, but perhaps unintended, preference provided for cost recovery of debt financed property if it is administratively feasible to do so. See discussion at 1131 and 1132.

39/See, e.g., Magill, The Impact of Federal Taxes (Columbia University Press, 1943).

40/Id., at 6.

41/Id.

42/Id., at viii.

43/Abdel-Khalik and Ajinkya, Empirical Research in Accounting: A Methodological Viewpoint contains an excellent discussion of internal and external validity considerations for empirical financial accounting research.

44/In empirical studies, the internal validity of the study is a function of the specific research design employed to statistically, physically, or otherwise control for the effect of as many potentially confounding or intervening variables as possible. In order for a study to have an acceptable level of internal validity, the research design must be sufficiently robust to support a conclusion that the observed changes in the dependent variable(s) were more likely to be the result of the observed or manipulated changes in the independent variable(s) than of changes in one or more of the unidentified intervening confounding variables. See generally Kerlinger, Foundations of Behavioral Research.

45/See, e.g., Report of the Chairman of the Subcomm. on Telecommunications, Consumer Protection, and Finance of the Comm. on Energy and Commerce (U.S. House of Representatives), Corporate Takeovers: Public Policy Implications For The Economy and Corporate Governance, 99th Cong., 2d Sess. (Comm. Print 99-QQ 1986). The most relevant Committee Reports included Staff of the Senate Comm. on Finance, The Reform and Simplification of the Income Taxation of Corporations and Staff of Joint Comm. on Taxation, Tax Reform Proposals: Corporate Taxation, 98th Cong., 1st Sess. (Joint Comm. Print 1985).

46/See, e.g., M. DeCelles, "An Examination of the Factors Affecting the Judicial Assessment of Continuity of Interest in Corporate Reorganizations." See also Leduc, "Current Proposals to Restructure The Taxation of Corporate Acquisitions and Dispositions: Substance and Process," 22 San Diego L. Rev. 17 (1985); Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web," 133 U. Pa. L. Rev. 1335 (1985); Shaw, "Impact of Proposals on Acquisitions Of Closely Held Corporations," 22 San Diego L. Rev. 289 (1985); Faber, "Taxation of Corporations And Shareholders: Premises Of The Present System," 22 San Diego L. Rev. 5 (1985); Ginsburg, "Special Topics In The Acquisitions Area," 22 San Diego L. Rev. 159 (1985); Thompson, "A Comparison Of The Merger And Acquisition Proposals Of Present Law With The Provisions In the Senate Finance Committee's Draft Bill," 22 San Diego L. Rev. 171 (1985); and Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions," 5 Va. Tax Rev. 599 (1986).

47/Data sources consulted include Andrews, Federal Income Taxation of Corporate Transactions (Little Brown and Company, 1979); Holzman, Corporate Reorganizations--Their Federal Tax Status (The Ronald Press Company, 1956); Holzman, Tax-Free Reorganizations (Farnsworth Publishing Company, 1976); Miller, Hendricks, and Everett, Reorganizations and Other Exchanges in Federal Income Taxation (The Ronald Press Company, 1931); and Surrey, Warren, McDaniel, and Ault, Federal Income Taxation (The Foundation Press, 1973).

48/See Bittker, "Income tax loopholes and political rhetoric (part 1)," 4 Tax Adviser 708 (1973); Bittker, "Income tax loopholes and political rhetoric (part 2)," 5 Tax Adviser 17 (1974); Blum and Penick, "The AILJ Enduring Principles for Tax Reform," 64 TAXES 100 (1986); Couzin, "The Process of Simplification," 32 Can. Tax J. 487 (1984); Eisenstein, The Ideologies of Taxation (The Ronald Press Company, 1961); Gensler, "A Simplified Internal Revenue Code," 63 TAXES 279 (1985); Graetz and Wilde, "The Economics of Tax Compliance: Fact and Fantasy," XXXVIII Nat'l Tax J. 355 (1985); Haskell, "Tax Policies--What Does the Future Hold?" 36 Tax Law. 1 (1984); Hettich and Winer, "Blueprints and Pathways: The Shifting Foundations of Tax Reform," XXXVIII Nat'l Tax J. 423 (1985); Pechman (ed.), The Promise of Tax Reform (Prentice-Hall, 1985); Lubik and Brannon, "Stanley S. Surrey and the Quality of Tax Policy Argument," XXXVIII Nat'l Tax J. 251 (1985); Phypers, "A Businessman's View of Tax Reform," XXXVIII Nat'l Tax J. 285 (1985); Steuerle, "The Prospects for Tax Reform," XXXVII Nat'l Tax J. 291 (1985); Surrey, Pathways to Tax Reform (Harvard University Press, 1973); U.S. Treasury Department, Blueprints for Basic Tax Reform (1977) reprinted in McIntyre, Sander, and Westfall, Readings in Federal Taxation (The Foundation Press, 1983) at 29-46; Brannon, "Some Economics of Tax Reform, 1986," XXXIX Nat'l Tax J. 277 (1986); Fullerton, "The Use of Effective Tax Rates in Tax Policy," XXXIX Nat'l Tax J. 285 (1986); McClure, "Tax Competition: Is What's Good For The Private Goose Also Good For The Public Gander?" XXXIX Nat'l Tax J. 341 (1986); and White, "A Long View of Tax Reform," XXXIX Nat'l Tax J. 255 (1986).

49/See Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1984); Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1985); Staff of Joint Comm. on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1985), Staff of Joint Comm. on Taxation, Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (And S. 420, S. 476, S. 632): Hearings Before Subcomm. on Taxation and Debt Management of the Comm. on Finance (Joint Comm. Print 1985); and Staff of Joint Comm. on Taxation, Special Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations: Hearings Before Subcomm. on Select Revenue Measures of the Comm. on Ways and Means (Joint Comm. Print 1985).

The most relevant Congressional hearings on the acquisition proposals include Reform of Corporate Taxation: Hearings Before the Comm. on Finance, U.S. Senate, 98th Cong., 1st Sess. (S. Hrg. 98-556 1983) and Staff Recommendations to Revise Subchapter C: Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance, U.S. Senate, 99th Cong., 1st Sess. (S. Hrg. No. 99-506 1985).

50/As discussed throughout this Study, the Subchapter C Revision Act of 1985 would do much to eliminate the current statutory and judicial conceptions of a "tax-free acquisitive reorganization" which many commentators feel are outdated and needlessly complex. The Act proposes that the statute contain an elective taxing regime for "qualified acquisitions." Proponents of the Act believe that by providing a more functional and rational classification scheme in which all types of acquisitive transactions under the 1986 Code are or are not treated as "qualified acquisitions," many of the hypertechnical, complex, and often dysfunctional definitional and operative distinctions found in the current law for tax-free reorganizations can be eliminated.

51/Magill, <u>Taxable Income</u> at 11.

52/<u>Id</u>.

53/<u>Id</u>., at 13. Magill notes that in analyzing judicial opinions, the researcher must recognize that the opinions "are the expressions of the modes of thought and conclusions of hundreds of different judges with as many different backgrounds of education and experience." <u>Id</u>.

54/<u>Id</u>., at iv.

55/The possibility of researcher bias in performing tax research and techniques to cope with such bias are discussed in Copeland, Taylor, and Brown, "Experimental Error in Tax Modeling Research," (Working Paper in Accounting No. 79-16, The University of South Carolina, 1979).

56/<u>See generally</u> D'Alexander and Sfafasz, "State tax aspects of corporate mergers and acquisitions," 18 <u>Tax Adviser</u> 236 (1987) and Brode, <u>Tax Planning for Corporate Acquisitions</u> (Prentice Hall/Rosenfeld Launer Publications, 1988) at 12-1 through 12-15 [Chapter 12, State Tax Implications of Corporate Acquisitions].

57/Majchrzak, <u>Methods For Policy Research</u> at 20.

Endnotes--Chapter III

1/Sec. 338 was created in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. Sec. 338 replaced Sec. 334(b)(2), which was added to the Code in 1954. Unlike Sec. 334(b)(2) which required the subsidiary to actually liquidate into its parent, Sec. 338 allows the parent corporation to make the statutory election, have the target undergo a hypothetical liquidation, and treat the acquisition as one of target assets instead of target stock.

The philosophy and operation of Sec. 334(b)(2) is discussed in Schnee, "Acquiring assets by purchasing corporate stock (part I)," 13 Tax Adviser 260 (1982) and Schnee, "Acquiring assets by purchasing corporate stock (part II)," 13 Tax Adviser 354 (1982).

The philosophy and operation of Sec. 338 is discussed in Hoops, "Acquiring the stock of a target--the Sec. 338 election," 15 Tax Adviser 138 (1984) and Schadewald, "Sec. 338: structuring a tax reimbursement agreement," 15 Tax Adviser 260 (1984). The recently issued and highly technical consistency requirements for Sec. 338 elections are discussed in Buchholz, "The Consistency Requirements of Section 338--Inconsistencies and Incongruities," 13 J. Corp. Tax'n 283 (1987).

The statutory election in Sec. 338 was presented to Congress as providing simplification over the prior Sec. 334 (b)(2). Sec. 338 transactions have proven to be very complicated in practice. Most commentators feel the Sec. 338 experience does very little to increase the chances that the proposal to make the corporate level tax consequences of qualified acquisitions explicitly elective will ever be enacted by Congress.

2/See, e.g., Faber, "The Search for Consistency in Corporate Acquisitions," 13 J. Corp. Tax'n 187 (1986); Ginsburg, "Taxing Corporate Acquistions," 38 Tax L. Rev. 171 (1983); Jacobs, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (1980); Krane, "Current Problems in Acquisitive Reorganizations," 51 TAXES 737 (1973); and Sandberg, "The Income Tax Subsidy to 'Reorganizations'" 38 Colum. L. Rev. 98 (1938). See generally American Institute of Certified Public Accountants, Statement of Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises (1979).

3/Staff of the Senate Finance Committee, 98th Cong., 1st Sess., The Subchapter C Revision Act of 1985 (S. Prt. 99-

47 1985) (hereafter Subchapter C Revision Act). The historical development of the recommendations contained in the Subchapter C Revision Act is discussed in the text infra.

The acquisition proposals contained in the Subchapter C Revision Act provide one unified taxing scheme for acquisitive transactions broadly defined. One of the overall goals of the Subchapter C Revision Act is to consolidate, simplify, and make uniform the tax consequences for acquisitive transactions whether classified under the 1954 Code as tax-free reorganizations, liquidating sales under Sec. 337 (the 12-month complete liquidation provisions), or stock acquisitions treated as asset acquisitions under Sec. 338. These transactions are called "qualified acquisitions" (QAs) under the Act. One of the major objectives of the ALI Studies and the Subchapter C Revision Act is to eliminate the categorical distinctions between the various types of economically similar acquisitive transactions which existed under the 1954 Code and are continued into the 1986 Code because the acquisition proposals have not been enacted. See Subchapter C Revision Act at 50.

4/Together with the transactional forms defined in Sec. 368(a)(1), the common law doctrines of continuity of interest, continuity of business enterprise, and business purpose serve as prerequisites to tax-free reorganization treatment under current law. Although these judicially created doctrines have been incorporated in the Regulations issued under Sec. 368 for a number of years, this Study will follow the convention used in the tax literature of referring to these doctrines as "judicial doctrines" or as "judicial requirements." This convention is helpful in distinguishing the definitional and operative provisions of the Code as enacted by Congress from attempts by the judiciary and the Internal Revenue Service (the Service) to protect the integrity of the statutory provisions from various taxpayer schemes to obtain unwarranted federal income tax benefits.

The continuity of interest doctrine is contained in Regs. 1.368-1(b) and 1.368-2(a), the continuity of business enterprise doctrine is contained in Regs. 1.368-1(b) and 1.368-1(d), and the business purpose doctrine is contained in Regs. 1.368-1(b) and 1.368-1(c). Regs. 1.368-5(d)(5) contains five examples of how the Service has interpreted the asset continuity and the business continuity aspects of the continuity of interest requirement.

The Subchapter C Revision Act would repeal each of these judicial doctrines as a prerequisite for tax-free (i.e., qualified acquisition) treatment at the target corporation or target shareholder or security holder level. However, the Tax Reform Act of 1986 has made the continuity of business enterprise requirement even more important for tax-free reorganizations than it was under the 1954 Code. Sec. 382(c)(1) now provides that under certain circumstances, no net operating losses of the target (loss) corporation may be used by the acquiring corporation if the loss corporation or its survivor does not satisfy the continuity of business enterprise requirement applicable to tax-free reorganizations. Sec. 382, as amended by the Tax Reform Act of 1986, and related tax planning issues are discussed in Mullaney and Bailine, "Corporate acquisitions after the Tax Reform Act of 1986," 17 Tax Adviser 212 (1987) at 213-215; Wooten, "Section 382 After the Tax Reform Act of 1986," 64 TAXES 874 (1986); and Worthy, "Subchapter C--loss carryovers following reorganizations and changes in ownership," 18 Tax Adviser 226 (1987).

5/Although the boundaries between the step transaction doctrine and the business purpose doctrine are not completely settled, most commentators treat the step transaction doctrine as another judicial safeguard used by the Service and the courts to prevent abuse of the tax-free reorganization provisions. See Kovey, "Characterizing Reorganizations by Reference to the Historic Shareholders," 5 J. Corp. Tax'n 115 (1978); Blanchard, "The effect of the step-transaction doctrine on reverse subsidiary mergers: An analysis," 55 J. Tax'n 72 (1981); and Blanchard, "Creeping Asset Acquisitions After TEFRA: On Reconciling the Irreconcilable," 38 Sw.L.J. 1053 (1985).

6/P. L. 99-154, 100 Stat. 2085 (October 22, 1986). See generally Harris, "A Brief History of the Tax Reform Act of 1986," 1 Prac. Tax Law. 1 (1987) and Eustice, Kuntz, Lewis, and Deering, The Tax Reform Act of 1986 Analysis and Commentary (Warren, Gorham & Lamont, Inc., 1987).

7/See Appendix. In reviewing the historical development of the definitional and operative statutory provisions, and the related judicial doctrines, the previous Congressional policy of periodically reenacting the entire body of federal income tax law in successive Revenue Acts will be observed. Until the first codification of the federal income tax law in 1939, each periodic Revenue Act represented the entire body of tax law in the United States. The enactment of the 1939 Code, which was approved by Congress on February 10, 1939, did not, in and of itself, change the federal income tax laws of the

United States. The 1939 Code was a codification, rearrangement, and a consolidation of all federal income tax laws enacted by Congress prior to January 3, 1939. A discussion of the process of codifying all prior Revenue Acts in to the 1939 Code is contained in 53 Stat. (Part 1) 1 at iii-iv and Secs. 1 through 6 of the 1939 Code.

8/The current merger wave in the United States (i.e., mergers and acquisitions which have occurred in the 1980s) has been described as the "megamerger" wave by Davidson and other commentators because both the acquiring corporation and the target corporation are typically large publicly-held corporations. The fact that large publicly-held corporations have been target corporations in hostile takeovers often financed with junk bonds and the frequent use of cash, rather than stock, consideration most distinguishes the megamerger wave from the conglomerate merger wave of the late 1960s in the United States. See generally Davidson, Megamergers (Ballentine Pub. Co., 1985) at xiii-xiv.

Much of the literature has described the megamerger boom from both an aggregate and an individual transaction perspective, but has yet to reach any generally accepted explanation for why mergers and acquisitions occur, why mergers and acquisitions occur in waves, and the role that the federal income tax laws play in merger and acquisition decisions. For a discussion of whether mergers and acquisitions occur in waves in the United States, see Golbe and White, "A Time-Series Analysis of Mergers and Acquisitions in the U.S. Economy," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences (University of Chicago Press, 1988) at 265-302.

The lack of an accepted theory for why mergers and acquisitions occur and the role played by federal income taxes makes the task of convincing Congressmen that the tax policy and technical problems discussed in this Study should be addressed in the manner suggested by the acquisition proposals very difficult. Financial analysts have no generally accepted theory to explain why mergers and acquisitions occur. See, e.g., Block, Inside Investment Banking (Dow Jones-Irwin, 1986) at 91-92.

The fact that much of the empirical research has been performed by economists who often lack a technical tax background and much of the tax policy research is nonempirical research performed by tax attorneys (and to a much lesser extent tax accountants) who often lack a sound understanding of how empirical research is performed and the related statistical techniques complicates the task of convincing

Congress of the need for comprehensive tax reform in the acquisitions area of the law.

The December 29, 1987, Wall Street Journal contained two advertisements that demonstrate the large dollar amounts involved in merger and acquisition transactions in calendar year 1987. Merrill Lynch Capital Markets announced that in 1987 it successfully completed merger and acquisition transactions for 86 clients with the consideration involved having a total market value of more than $29 billion. Id., at 19. Donaldson, Lufkin & Jenrette, Inc. announced that it had been involved in merger and acquisition transactions in calendar year 1987 for 48 clients with the consideration involved having a total market value of over $10 billion. Id., at 29.

The number of merger and acquisition transactions completed in calendar year 1988 indicates that the megamerger era is continuing. Business Week reports that by December 31, 1988, "takeover specialists had closed 42 transactions each worth $1 billion or more--a record by far. . . . The average price of a deal climbed 39%, to $130 million." Dobrzynski, "The Top 200 Deals," Bus. Wk. (1989 Special Edition, April 1989) at 35.

9/See, e.g., Scholes and Wolfson, "The Effect of Changes in Tax Laws on Corporate Reorganization Activity" (Working Paper, Stanford University Graduate School of Business, April 1989). Scholes and Wolfson conclude that the federal income tax laws have played an important role in the megamerger boom in the United States in the 1980s. The authors follow much of the economic literature in noting that mergers and acquisitions are often valid alternatives to other forms of business expansion, e.g. de novo entry into new lines of business. Scholes and Wolfson conclude that the repeal of the 1954 Code corporate level nonrecognition provisions based on the General Utilities doctrine and the imposition of a more comprehensive corporate alternative minimum tax in the Tax Reform Act of 1986 will discourage merger and acquisition transaction between United States corporations. The authors conclude that the Tax Reform Act of 1986 will increase the demand for merger and acquisition transactions between United States selling corporations and foreign based buying corporations.

As discussed in more detail in Chapter IV of this Study, the empirical literature has generally been unable to clearly separate the tax and nontax motives for mergers and acquisitions or to explain why so many of the current megamergers have so frequently involved a high percentage of cash consideration. See generally Auerbach and

Reishus, "The Effects of Taxation on the Merger Decision," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 157-187.

Business Week reports, for example, that virtually all of the mergers and acquisitions involving publicly-held corporations during calendar year 1987 were all cash transactions. See "Deal Mania: Tax Reform is Not Tranquilizer After All," Bus. Wk. (March 30, 1987) at 66. Some commentators note that cash-rich European corporations have a number of sound business reasons to use available cash for acquisitions and a number of equally sound reasons not to use any form of junk bonds or the more traditional equity financing. See Riemer, Melcher, Capstein, Comes and Symonds, "A Cash Rich Europe Finds The U.S. Ripe for Picking," Bus. Wk. (January 15, 1988) at 48 and Salwen, "An Appraisal: Foreign Takeovers of U.S. Firms to Surge, Some Say," Wall St. J. (January 11, 1988) at 43.

For some academic insights into the use of cash consideration, see Franks, Harris and Mayer, "Means of Payment in Takeovers: Results for the United Kingdom and the United States," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 221-258; Hansen, "A Theory for the Choice of Exchange Medium in Mergers and Acquisitions," 60 J. Bus. 75 (1987); Jensen, "Agency costs of free cash flow, corporate finance and takeovers," 76 Am. Econ. Rev. 323 (1986); and Grossman and Hart, "Takeover bids, the free-rider problem, and the theory of the corporation," 11 Bell J. Econ. 42 (1980). Jensen believes the increased use of cash consideration in merger and acquisition transactions can be explained in part by a manager's desire for power and job security. If managers use the free cash flow (i.e., cash flow in excess of that needed to internally fund projects having a positive net present value) available to them to make acquisitions, the manager can increase his power. Grossman and Hart note that cash is often used as the first part of a two-tier tender offer to force target shareholders to tender enough shares in order that the acquiring corporation receives the minimum number of shares desired (often 80 percent or more) and to eliminate the free-rider problem (i.e., target shareholders tender their shares after the market forces surrounding the announced merger bid have bid up the market price of their shares).

Other researchers note that the use of cash consideration can provide a tactical advantage in the fast-moving world of mergers and acquisitions, may reduce regulatory and other acquisition costs, and may increase the probability that the acquisition will be consummated on terms favorable to the acquiring corporation. As a general rule, stock tender offers must be approved by the Securities and Exchange Commission, a process which often allows management of the target corporation time to mount a defense to a proposed takeover (e.g., challenge the takeover on legal or antitrust grounds or find a more acceptable acquiring corporation--a white knight). Cash tender offers generally limit the time frame in which management of the target corporation can respond to tender offers, particularly hostile offers. See generally Haung and Walkling, "Target Abnormal Returns Associated with Acquisition Announcements," 19 J. Fin. Econ. 329 (1987).

Both the empirical and tax literature indicate that in spite of the repeal of the corporate level nonrecognition provisions based on the General Utilities doctrine, the use of two-tier tender offers will continue to be popular under the 1986 Code. In the typical two-tier tender offer, the acquiring corporation accepts a limited number of target shares under a prorationing plan in exchange for cash with the intention of a subsequent merger of the target into the acquiring corporation with acquiring corporation stock used as the consideration. Under the 1954 Code, all-cash takeovers could often be structured as a liquidating sale of the target under Secs. 336 and 337 or as a Sec. 338 transaction. The acquiring corporation could take a fair market value basis in the target's assets, the target corporation did not recognize all gain realized, and the gain recognized by the target shareholders was generally characterized as long-term capital gain. See Willens, "Benefits of Cash-Option Mergers Include Favorable Dividend Taxation," 70 J. Tax'n 272 (1989).

Comment and Jarrell note that the repeal of the General Utilities doctrine will cause the acquiring corporation to change its tactics:

> . . . [the Tax Reform Act of 1986] disfavor[s] all-cash transactions in relation to their previous treatment by eliminating the General Utilities doctrine which had allowed an avoidance (though liquidation) of the target's corporate-level gain on any asset write-up. Bidders who want to use as much cash as possible and still avoid a corporate-level taxable gain can do either a two-tier cash offer for up to half of the shares with a share-exchange for the rest, or a single-step merger with shareholders allowed to elect to receive cash for up to half of the outstanding shares.

Comment and Jarrell, "Two-Tier and Negotiated Tender Offers," 19 J. Fin. Econ. 283 (1987) at 290.

Under both the 1954 and 1986 Codes, the type of two-tier tender offer described above can be structured as a tax-free statutory merger under Sec. 368(a)(1)(A) if the continuity of interest doctrine is satisfied. Given the Service's advance ruling position in Rev. Proc. 77-37, 1977-2 CB 368 (the acquiring corporation must use stock consideration equal to at least fifty percent of the value of the target stock), the overall transaction can be an "A" reorganization. Comment and Jarrell conclude that the 1986 Code allows "some shareholders to continue to defer personal capital-gain taxes without the bidder's having to forgo the timing advantage of a cash tender offer . . ." Id., at 290.

Despite the impression given by the popular press, the number of hostile takeovers completed each year is very small. In a 1984 study of the 1,786 acquisitions of publicly-held corporations which took place between 1976 and 1984, over 90 percent were negotiated transactions, 28 percent involved tender offers, and less than five percent resulted from hostile tender offers. See W.T. Grimm & Co., Mergerstat Review 1984 (1985) at 90-96.

10/The management literature describes many of the effects of the megamerger boom in the United States but has yet to provide a generally accepted explanation for why mergers and acquisitions occur. The literature agrees that it is very difficult to evaluate the long-term economic, social, and other aspects of corporate takeovers, particularly hostile takeovers. See, e.g., Myers, "Will Mergers Help or Hurt in Long Run?" Wall St. J. (May 2, 1987) at 1; Johnston Takeovers (Arbor House, 1986); and Wright, Hotard, Tanner and Kroll, "Research Note: Relationship of Selected Variables and Business Performance of Diversified Corporations," VI Am. Bus. Rev. 71 (1988). Wright et. al. note that the strategic management literature has a practical instead of a theoretical foundation and it is therefore generally of little assistance in addressing theoretical matters. See also Varaiya and Ferris, "Overpaying in Corporate Takeovers: The Winner's Curse," 43 Fin. Analy. J. 64 (1987) (arguing that the successful bidder is often the one who most overpays for the target).

Two principal management writers, Drucker and Waterman, are very critical of the effects of the megamerger boom in the United States. See generally Drucker, The Frontiers of Management (E. P. Dutton, 1986) and Waterman, The Renewal Factor (Bantam Books, 1987). Drucker states that corporate takeovers (particularly hostile takeovers) raise a number of public policy questions and issues which have not been critically analyzed. Drucker argues that the current takeover wave is a symptom of fundamental changes occurring in the economic structure of the United States economy and the environment in which American business will operate in the future. See Id., at 245. Drucker offers three possible explanations for the megamerger boom: (1) inflation (which makes it more economical for corporations to acquire other business rather than to develop new lines of business internally); (2) structural changes in the economy (which make many of yesterday's successful corporations, such as the large integrated petroleum companies, no longer appropriate to the present economic realities); and (3) corporate capitalism (in which corporate management acts as if it is accountable only to itself and which leaves the corporation extremely vulnerable to hostile takeovers). See Id., at 245-255. Drucker states that hostile takeovers "clearly are not the right tool to bring about a more efficient allocation [of economic resources]." Id., at 245.

Waterman argues that many of the problems currently facing American business are the inevitable result of past inactions or mistakes of management and that the threat of a hostile takeover has profoundly affected all American corporations. Waterman believes that the megamerger boom is only partly due to the relaxation of antitrust and other regulatory pressures during the Reagan years and that many corporate takeovers can be explained by the fact that managers did not keep their corporations competitive on a world-wide basis. Waterman feels one of the major policy issues for megamergers is whether any one individual or any group can manage the resulting corporations with their huge debt and pressing need to institute cost containment programs. See Waterman, The Renewal Factor at 20-22, 130-131, and 311.

The academic literature suggests that corporate takeovers are an indirect, but potent, means by which shareholders can renegotiate their contracts with management. When a firm's environment changes, the relationship between management and shareholders may become outdated. Due to the asymmetric information about the firm (i.e., the managers typically know much more about the firm than the shareholders), managers may take inefficient actions and direct some of the firm's value to themselves. The threat of a hostile takeover presumably forces a goal congruence between managers and shareholders of a firm. See Grossman and Hart, "Takeover bids, the free-rider problem, and the theory of the corporation" and Scharfstein, "The Disciplinary Role of Takeovers," LV Rev. of Econ. Studies 185 (1988).

Many commentators are concerned that the huge amount of debt created in completed and uncompleted takeovers virtually guarantees that the acquiring corporation or the still independent potential target corporation will have to institute severe cost containment programs (which may well damage the ability to compete effectively) and will have to sell off major parts of the target corporation in order to pay off the enormous debt and legal and other professional fees. See, e.g., "Losers Win in Mergers," St. Louis Post-Dispatch (April 24, 1988) at 1F (noting that in Campeau Corporation's hostile takeover of Federated Stores Inc. the investment banking and legal fees amounted to over $200 million). See also Kristol, "A Cure for Takeovers' Social Ills," Wall St. J. (May 13, 1988) at 14 (observing that managers have responded in a "predictable manner" to the threat of corporate takeovers: they have leveraged the corporation in order to repurchase shares and otherwise attempt to maximize the current market price of the corporation's stock). The extent to which corporations have increased their leverage in order to fund stock repurchases and taken other defensive measures is discussed in Shoven, "The Tax Consequences of Share Repurchases and Other Non-Dividend Payments to Equity Owners," in Summers (ed.), Tax Policy and the Economy (MIT Press, 1987) at 29-54.

Many commentators have concluded that the federal and state securities and corporations laws do not provide adequate protection to shareholders and other stakeholders (e.g., employees, creditors, and the community in which the corporation operates) of corporations involved in takeovers. See, e.g., Kristol, "A Cure for Takeovers' Social Ills" (arguing that a corporation is a sociological institution as well as an aggregation of economic assets and that those who advocate an unimpeded market for corporate control have given much too little credence to the human costs of takeovers). See also Report on Hostile Takeovers discussing the role played by risk arbitragers in corporate takeover contests.

Several commentators are concerned that the federal government will follow the lead of several states, most notably Delaware in which approximately fifty percent of the Fortune 500 corporations are incorporated, in enacting some type of antitakeover legislation. These issues are discussed in Bandow, "Are Hostile Takeovers Good for the Economy?" 63 Bus. & Soc. Rev. 45 (Fall 1987) and Pound, "The Effects of Antitakeover Amendments on Takeover Activity," XXX J. L. & Econ. 353 (1987) (noting that as of December 1986, about forty percent of the Fortune 500 corporations had adopted some form of antitakeover, so-called sharp repellant, amendments to their corporate charters).

11/The tax literature contains detailed discussions of both the Preliminary Staff Proposals and the final acquisition proposals contained in the Subchapter C Revision Act. See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process," 22 San Diego L. Rev. 17 (1985); Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web," 133 U. Pa. L. Rev. 1335 (1985); Shaw, "Impact of Proposals On Acquisitions Of Closely Held Corporations," 22 San Diego L. Rev. 289 (1985); Faber, "Taxation Of Corporations And Shareholders: Premises Of The Present System." 22 San Diego L. Rev. 5 (1985); Ginsburg, "Special Topics In The Acquisitions Area," 22 San Diego L. Rev. 159 (1985); Thompson, "A Comparison Of The Merger and Acquisitions Proposals Of Present Law With The Provisions In the Senate Finance Committee's Draft Bill," 22 San Diego L. Rev. 171 (1985); and Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions," 5 Va. Tax Rev. 599 (1986).

12/The initial proposals for changes in the federal income tax law for acquisitive transactions (in which acquisitive transactions are defined much more broadly than tax-free reorganizations) was issued as Comm. on Finance, The Reform and Simplification Of The Income Taxation of Corporations, 98th Cong., 1st Sess. (S. Prt. 98-95 1983) (hereafter Preliminary Staff Proposals). The final report of the staff of the Comm. on Finance was issued as the Subchapter C Revision Act. As is the case for the Subchapter C Revision Act, the objectives of the acquisition proposals contained in the Preliminary Staff Proposals were: (1) to simplify the taxation of corporate transactions; (2) to prevent corporations and their shareholders from obtaining unintended tax benefits; (3) to make the tax law more neutral with respect to structuring corporate transactions; and (4) to improve compliance with the tax laws.

13/See Reform of Corporate Taxation: Hearings Before the Comm. on Finance, 98th Cong., 1st Sess. (S. Hrg. 98-556 1983) (hereafter 1983 Hearings on Reform of Corporate Taxation); Staff Recommendations to Revise Subchapter C: Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance, 99th Cong., 1st Sess. (S. Hrg. No. 99-506 1985) (hereafter 1985 Hearings on Reform of Corporate Taxation); Staff of the Joint Comm. on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions: Hearings before Subcomm. on Oversight and the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means (Joint Comm. Print 1985) (hereafter Tax Aspects of Mergers and Acquisitions); and Staff of the Joint Comm. on Taxation, Federal Income Tax Aspects of Hostile Takeovers And Subcomm. on Taxation and Debt Management of the Comm. on Finance (Joint Comm. Print 1985) (hereafter Report on Hostile Takeovers).

14/Detailed discussions of the historical development of the federal income tax law applicable to corporations and their shareholders generally and the specific topic of tax-free reorganizations are contained in Andrews, Federal Income Taxation of Corporate Transactions (Little Brown and Company, 1979); Baar, "Corporate Reorganizations," 27 TAXES 697 (1949); Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (Warren Gorham & Lamont, Inc., 4th ed., 1979); Blakey and Blakey, The Federal Income Tax (Longmans, Green & Co., 1940); Davis, Corporate Acquisitions and Dispositions of Businesses (Mark A. Stephens, Ltd., 1974); Holzman, Corporate Reorganizations-Their Federal Income Tax Status (Ronald Press Company, 1956) [hereafter Corporate Reorganizations]; Holzman, Tax-Free Reorganizations (Farnsworth Publishing Company, 1976); Magill, The Impact of Federal Taxes (Columbia University Press, 1943); Magill, Taxable Income (Ronald Press Company, 1945); Mertens Law of Federal Income Taxation, Vol. 3, Sections 19.01 through 20.192 (Callaghan & Co., 1981 Rev. Ed., Ziwe and Weiss Revision); Miller, Hendricks, and Everett, Reorganizations and Other Exchanges in Federal Income Taxation (Ronald Press Company, 1931); Randolph and Mertens, Jr., The Law of Federal Income Taxation (Callaghan and Company, 1934); Seligman, Essays in Taxation (August M. Kelley Publishers, 1969); Surrey, Warren, McDaniel, and Ault, Federal Income Taxation (Foundation Press, 1973); and Swartz, "Recapitalizations," 24 TAXES 298 (1946).

15/Detailed discussions of the historical development of the three judicial doctrines and current problems with these doctrines are contained in Aidinoff and Lopata, "The Continuity of Business Enterprise Requirement and Investment Company Reorganizations," 58 TAXES 914 (1980); Baker, "Continuity of Interest Requirement in Reorganizations Reexamined--The Hickok Case," 18 Inst. on Fed. Tax'n (1960) at 761; Bittker, "Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code," 21 How. L.J. 693 (1978); Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise," 7 J. Corp.

Tax'n 315 (1981); Brown, Berkowitz and Lynch, "McDonald's of Zion: application of the step-transaction doctrine to the continuity of interest test," 12 Tax Adviser 580 (1981); Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations," 45 J. Tax'n 130 (1976); Dailey, "The Voting Stock Requirement of B and C Reorganizations," 26 Tax L. Rev. 725 (1971); Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" 34 Tax Law. 239 (1981); Ferrero, "Continuity of Interest Revisited," 40 Inst. on Fed. Tax'n (1982) at 44-3; Fuller, "Business Purpose, Sham Transaction And The Relaxation of Private Law To The Law of Taxation," XXXVIII Tul. L. Rev. 355 (1963); Halpert, "Continuity of Business Enterprise Regulations Invigorates a Dormant Doctrine," 40 Inst. on Fed. Tax'n (1982) at 50-1; Holzman, "Thirty Years of the Gregory Case," 119 J. Acct. 34 (1965); Laurie, "The Business Purpose Doctrine," 25 TAXES 800 (1947); Libin, "Continuity of Business Enterprise: The New Regulations," 39 Inst. on Fed. Tax'n (1981) at 4-2; Mandelkern, "'Continuity of Business Enterprise' And The Liquidation-Reincorporation Battle: Is Treasury Regulation Sec. 1.368-1(d) A Trojan Horse?" XXXIV U. Fla. L. Rev. 822 (1982); Maxwell, "Continuity of Interest in Recapitalizations and Mergers," 40 TAXES 1003 (1962); McGaffey and Hunt, "Continuity of Shareholder Interest in Acquisitive Reorganizations," 59 TAXES 659 (1981); Michaelson, "'Business Purpose' and Tax-Free Reorganizations," 61 Yale L.J. 14 (1952); Rice, "Judicial Techniques In Combating Tax Avoidance," 51 Mich. L. Rev. 1021 (1953); Ruppert, "Proposed Treasury Regulation Section 1.368-1(d): The Continuity of Business Enterprise Test," 29 De Paul L. Rev. 723 (1980); Soukup, "The Continuity-of-Proprietary-Interest Doctrine and Thrift Institution Mergers," 12 J. Corp. Tax'n 141 (1985); Spear, "'Corporate Business Purpose' in Reorganizations," 3 Tax L. Rev. 225 (1947); Summers, "A Critique Of The Business Purpose Doctrine," 41 Or. L. Rev. 38 (1961); Tarleau, "'Continuity of Business Enterprise' in Corporate Reorganizations and Other Corporate Readjustments," 69 Colum. L. Rev. 792 (1960); and Warren, "The Requirement of Economic Profit in Tax Motivated Transactions," 59 TAXES 985 (1981).

16/In commenting on the evolution of the tax-free reorganization provisions, Posin states:

> More than in most areas of the tax law, the principles of corporate reorganizations are rooted in history. Some of the older principles still retain influence, and studying their historical evolution is a useful means of understanding their apparently

illogical application to present-day transactions.

Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web" at 1340.

17/In testifying on the Preliminary Staff Proposals, William Andrews, a Professor of Law at Harvard Law School and the Reporter for each of the ALI Subchapter C Projects from 1974 through 1982, noted the similarity of the 1982 ALI Study and the Preliminary Staff Proposals. Andrews asserted the similarity in recommendations for changes in the acquisition provisions of the 1954 Code from two quite independent working groups (i.e., the ALI and the staff of the Senate Finance Committee) does much to confirm the necessity for tax reform as well as the appropriateness of the acquisition proposals. Because common themes and solutions survived the test of examination and elaboration by the two independent groups, Andrews argued that Congress should be sensitive to the need for comprehensive tax reform in the acquisitions area of the law. See 1983 Hearings on Reform of Corporation Taxation at 74-76.

18/American Law Institute, Federal Income Tax Project Subchapter C Tentative Draft No. 1 (1977) (hereafter 1977 ALI Study).

19/American Law Institute, Federal Income Tax Project (1980) (hereafter 1980 ALI Study).

20/American Law Institute, Federal Income Tax Project Subchapter C--Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions (1982) (hereafter 1982 ALI Study). The overall philosophy, tax policies, and technical changes advocated in the ALI Studies are clearly evident in both the Preliminary Staff Proposals and in the final acquisition proposals. Background material on the 1982 ALI Study is contained in 1977 ALI Study and 1980 ALI Study. The 1977 and 1980 ALI studies are discussed in Beghe, "The American Law Institute Subchapter C Study: Acquisitions and Distributions," 33 Tax Law. 743 (1980).

21/Preliminary Staff Proposals. The Preliminary Staff Report discussed the many interrelated aspects of Subchapter C, including the elective corporate level taxing regime suggested by the various ALI studies for corporate acquisitions. Although the specific details varied somewhat, the 1982 ALI Study and the Preliminary Staff Report contained quite similar recommendations for acquisitive transactions. See n. 17 supra. Each of the recommendations of concern to this Study were contained in the

1982 ALI Study, the Preliminary Staff Report and the Subchapter C Revision Act. As discussed in the text infra, neither Treasury I nor Treasury II contained any detailed suggestions for the reform of the Code provisions which govern acquisitive transactions.

22/The 1982 ALI Study states:

> Transactions among corporations and their investors have raised basic, persistent, difficult problems throughout the history of the federal income tax. Such transactions were involved in a number of the earliest Supreme Court decisions defining taxable income. They have also been the subject of special statutory provisions from the beginning.

1982 ALI Study at 1.

23/Alternative taxing systems are discussed in Hubbard, "Tax Corporate Cash-Flow, Not Income," Wall St. J. (February 19, 1989) at A14; King, "The Cash Flow Corporate Income Tax," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation (University of Chicago Press, 1987) at 377-400; and Rudnick, "Corporate Tax Integration: Of Liquidity Of Investment," 42 Tax Notes 1107 (February 27, 1989). A proposal to eliminate the corporate tax is contained in Garrison, "Tax-Revision Sleight of Hand," Wall St. J. (October 3, 1986) at 20.

In 1962, Milton Friedman advocated the elimination of the corporate income tax, or if this was not politically feasible, taxing corporate earnings directly to the shareholders. According to Friedman, elimination of the corporate tax would do much to invigorate capital markets, to stimulate enterprise, and to promote economic competition. See generally Friedman, Capitalism and Freedom (University of Chicago Press, 1962). The principal reason for this recommendation was that while corporations would be free to retain as much of their earnings as they wished, there would be no income tax incentive to do so except the "proper" one that the corporation could use the funds more profitably than the shareholders could. See Id., at 132.

The American Institute of Certified Public Accountants has also criticized the double tax aspect of Subchapter C. See American Institute of Certified Public Accountants, Statement of Tax Policy No. 3: Elimination of the Double Tax on Dividends (1976).

24/The Joint Committee on Taxation states there is no question that the federal income tax laws influence 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 income taxation of corporate and individual income and the income taxation of gifts and estates. The interaction of these tax rules may affect the number and form of acquisitions, the type and amount of consideration paid, the tactics used in takeover contests, and the corporations that are candidates for becoming acquirers or targets. The Joint Committee states:

> Certain features of the corporate and individual income tax (as well as 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.

Tax Aspects of Mergers and Acquisitions at 3-4. <u>See also</u> Jacobs, "Reorganizing the Reorganization Provisions"; Morrissey, "Defensive Tactics In Tender Offers Does Anything Go?" 53 <u>Tenn. L. Rev</u>. 103 (1985); Palmieri, "Fiduciary Responsibilities Under ERISA in Corporate Takeovers," 13 <u>J. Corp. Tax'n</u> 127 (1986); Bowen, "Defenses Against Takeovers-Selected Tax Problems," 64 <u>TAXES</u> 835 (1986); Rosenberg, "The Reluctant Bride: Tax Treatment of Costs of Resisting Corporate Takeovers," 13 <u>J. Corp. Tax'n</u> 114 (1986); and Moore and Schuck, "Tax Aspects of Defensive Strategies to Corporate Takeovers," 69 <u>J. Tax'n</u> 212 (1988).

The Joint Committee on Taxation also notes that a number of nontax factors also play an important role in merger and acquisition decisions:

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

Report on Hostile Takeovers at 21.

There can be no question that the provisions of the Internal Revenue Code affect the decision by one corporation to acquire another corporation and whether the acquiring corporation will acquire the assets or the stock of the target corporation. Rappaport, for example, states:

> Generally, the maximum acceptable price for a target corporation is its stand-alone value plus the value of acquisition benefits generated by operating, financial and tax synergies.

Rappaport, "Stock market signals to managers" 65 Harv. Bus. Rev. 57 (1987) at 58.

Steiner's research into mergers and acquisitions suggests that if the combined company can make more profitable use of the existing tax law than the constituent companies or their stockholders the tax advantages of a merger are a form of synergy which may help to motivate a merger. See Steiner, Mergers: Motives, Effects, Policies (University of Michigan Press, 1975) at 78.

Davidson notes there are two basic types of tax benefits to be gained from a corporate takeover: those gained from the legal form of the acquisition and the tax savings which result from the formerly independent firms as a combined entity. See Davidson, Megamergers at 205.

The Joint Committee on Taxation notes that the megamerger boom in the 1980s in the United States has attracted much interest and concern from a public policy perspective because of the unprecedented size of corporations that have been acquired (some in hostile takeovers) and the costly and novel defensive (e.g, the Pac-Man defense in which the target attempts to takeover the acquiring corporation) and offensive strategies (e.g., lock-up maneuvers) that have been used in these huge takeover contests. See Tax Aspects of Mergers and Acquisitions at 4.

Davidson notes that although hostile or unfriendly takeover attempts have never amounted to more than five percent of the total number of mergers and acquisitions in an annual period, the 50 to 100 hostile takeovers attempted each year have had a profound effect on corporations and their employees and upon whether Congress perceives remedial legislation is necessary. Davidson, Megamergers at 2. See also Report on Corporate Takeovers.

Breen notes that the explicit and implicit tax policies for corporate acquisitions is an important public policy issue:

> If a significant number of inefficient mergers occurs because of these [tax] provisions, then these provisions are appropriately a matter of public policy concern. However, to the extent that tax incentives are incidental to a drive for efficiencies--for scale or scope economies, for instance--and do not affect merger decisions, the tax code need not be a source of concern for public policy in this area.

Breen, The Potential For Tax Gains As A Merger Motive (Bureau of Economics, Federal Trade Commission, 1987) at 1.

Testimony before Congress suggests that certain provisions of the 1954 Code, particularly the ability of the acquiring corporation to deduct interest payments on acquisition indebtedness, have contributed to the increase in volume and size of corporations involved in mergers and acquisitions in the United States in the 1980s. There can be no doubt that the tax policies contained in the 1954 and 1986 Codes (such as those reflected in the corporate level nonrecognition provisions based on the General Utilities doctrine) affect the decision to undergo a merger or acquisition and the form of the acquisition. Davidson feels that a common trigger for the megamerger wave in the United States in the 1980s is "the combination of a tax law which provides incentives for corporations to retain their earnings and a lack of corporate spending opportunities other than mergers." Davidson, Megamergers at xiv.

The form of an acquisitive transaction is influenced by the following factors: (1) the nature of consideration to be used; (2) opportunity to step-up the tax basis of the target's assets to fair market value; and (3) whether it is advantageous to preserve the target corporation's tax history. See Tax Aspects of Mergers and Acquisitions at 4.

The Joint Committee on Taxation has identified the following three aspects of the 1954 Code as having the most potentially significant effect on merger and acquisition activity:

1. The differing tax consequences of acquiring an entire corporation as opposed to acquiring individual corporate assets.

2. The disparate treatment of various forms of corporate

distributions made in the form of interest payments, dividends, and long-term capital gains.

3. The inability of corporations with limited taxable income to take full and immediate advantage of business tax preferences.

Tax Aspects of Mergers and Acquisitions at 4.

The Joint Committee on Taxation summarized the 1954 Code provisions which provided the most significant tax incentives for mergers and acquisitions and divided them into the following four categories:

1. Leveraged mergers. The deductibility of acquisition indebtedness may be responsible for some mergers. The Joint Committee on Taxation states:

> Debt-financed acquisitions effectively increase the debt-to-equity ratio of the acquired corporation and thus may increase share price to the extent that the tax advantages are not outweighed by the disadvantages (e.g., increased bankruptcy risk).

Tax Aspects of Mergers and Acquisitions at 4-5 and Report on Hostile Takeovers at 4. <u>See generally</u> O'Connor, "The Tax Functions, Effects and Other Business Uses and Benefits of Debt Under the New Interest Deduction Rules and Tax Rates: Some Guideposts Through the Mazes of the Code," 65 <u>TAXES</u> 954 (1987).

The Joint Committee on Taxation also states:

> In summary, the Code encourages leveraged acquisitions to the extent that the managers of the target corporations fail to exploit the tax advantages of debt financing. The Code also encourages the use of debt as payment in exchange for target stock because the shareholders may use the installment method of reporting to defer capital gains tax.

Tax Aspects of Mergers and Acquisitions at 11-12 and Report on Hostile Takeovers at 11-13. Knight and Knight note that well-advised taxpayers fully understand the economic advantages of reporting recognized gains on the installment basis and that sophisticated tax practitioners have often structured their clients' affairs to take advantage of installment reporting. <u>See</u> Knight and Knight, "Merger Mania: Did the Tax Reform Act of 1986 Reduce the Tax Incentives for Corporate Takeovers, Mergers and Acquisitions?" 40 <u>Tax Executive</u> 79 (1987) at 83. <u>See also</u>

Volpi, "Availability of the installment method is limited or eliminated after tax reform," 38 Tax'n for Acct. 18 (1987).

2. Churning mergers. The corporate level nonrecognition rules based on the General Utilities doctrine may be responsible for some mergers. Churning mergers are transactions primarily designed to establish a new fair market value basis for corporate assets which have previously been depreciated in the hands of the present corporate owner.

The tax literature almost universally agrees that the corporate level nonrecognition provisions contained in the 1954 Code encouraged mergers and acquisitions. See, e.g., Yin, "General Utilities Repeal: Is Tax Reform Really Going To Pass It By?" 31 Tax Notes 111 (1987). Willens asserts: "More than any other tax convention, this [General Utilities] doctrine fueled the early 1980s acquisition boom." Willens, "The Technical Corrections Act: What Corporations Should Know Now," 166 J. Acct. 46 (1988) at 48.

Breen disagrees with Willens and states that the bulk of transactions which utilized the corporate level nonrecognition rules under the 1954 Code typically involved smaller, nonpublicly traded corporations. See Breen, The Potential For Tax Gains As A Merger Motive at 2.

Davidson hypothesizes that the federal income tax laws affect mergers and acquisitions of smaller nonpublicly-held corporations to a much greater extent than is the case for larger publicly-held corporations. Davidson states that tax provisions can be "enormously important" when the owners of a closely-held corporation sell either the assets or the stock because the tax savings from properly structuring the sale can be very substantial when the founders have built-up the business over a long period of time by reinvesting the profits. In mergers and acquisitions of publicly-held corporations the corporate level tax consequences are often much more important than the shareholder level consequences. In addition, there may be more flexibility in large corporate takeovers to tailor the consideration to the individual tax situation of the shareholders (i.e., some shareholders can receive cash, others can receive only stock of the acquiring corporation). See Davidson, Megamergers at 205-206.

Knight and Knight state that under the 1954 Code version of Sec. 338, an acquiring corporation could often achieve a significant economic advantage, i.e., a stepped-up basis for the target's assets, not available to the target as an ongoing publicly-held corporation. Knight and Knight state:

> Cash flow generally increases because of the acquirer's ability under Section 338 to effectively redepreciate and redeplete the written-up assets on a purchase transaction.

Knight and Knight, "Merger Mania: Did the Tax Reform Act of 1986 Reduce the Tax Incentives for Corporate Takeovers, Mergers and Acquisitions?" at 80.

Lobenhofer notes that because the basis of the target corporation stock in the hands of the shareholders (i.e., outside basis) does not bear any necessary relationship to the basis of the assets held by the corporation (i.e., inside basis), the tax imposed on the shareholder (generally at long-term capital gain rates) under the 1954 Code complete liquidation and Sec. 338 transaction provisions did not bear any necessary relationship to the corporate level tax avoided under the corporate level nonrecognition rules in taxable transactions. Because the typical attractive target corporation held appreciated assets, the 1954 Code provisions (particularly the General Utilities doctrine) encouraged the sale of the entire corporation rather than individual assets. See Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences Of Incomplete And Unexpected Tax Reform," 4 Akron Tax J. 153 (1987) at 168.

In testimony before Congress, William Andrews stated that the repeal of the General Utilities doctrine " . . . would amerliorate the unproductive bias of the current law in favor of corporate acquisitions shaped to take advantage of the [corporate level] exclusion [of realized gain]." 1983 Hearings on Reform of Corporate Taxation at 72-73.

3. Distributive mergers. The combination of the General Utilities doctrine and the tax-free reorganization provisions of the 1954 Code may be responsible for some mergers. Distributive mergers are transactions primarily designed to distribute appreciated corporate assets to shareholders while avoiding the full recognition of gain realized at either the corporate or shareholder level.

The tax rate preference accorded to long-term capital gains of individual taxpayers encouraged corporations to completely liquidate or undertake mergers which produced capital gain rather than dividend income to the shareholders. In addition, undergoing a complete liquidation or a tax-free reorganization may have allowed corporations to avoid problems with the accumulated earnings tax. The Joint Committee on Taxation states:

> Thus, the Code creates an incentive for corporate transactions and financial policies which produce capital gains, whether currently taxable or deferred, rather than dividends for the individual shareholders.

Tax Aspects of Mergers and Acquisitions at 5 and Report on Hostile Takeovers at 6.

The nature and structure of federal gift and estate tax may have encouraged shareholders of nonpublic corporations to engage in tax-free reorganizations with publicly-held corporations. In a properly structured transaction, the shareholders and security holders of a nonpublic target corporation can receive publicly traded stock and securities without the immediate recognition of gain. The possibility of holding the more liquid stock and securities of a larger publicly-traded corporation is often attractive due to liquidity, valuation, and other estate and gift tax planning concerns of the owners and creditors of nonpublicly held corporations.

Tax Aspects of Mergers and Acquisitions at 6 and Report on Hostile Takeovers at 6.

4. Tax benefit transfer mergers. The desire to utilize the excess tax benefits and preferences that corporations often generated under the 1954 Code may be responsible for some mergers. Tax benefit transfer mergers are intended to circumvent various provisions of the Code (such as Secs. 269, 279, 382, and 383 and the consolidated return regulations) which attempt to limit or prohibit the direct sale of excess tax attributes from one corporation to another.

Because the 1954 Code did not tax all of the economic income of corporations and because corporations which could not immediately use all of their net operating losses and excess tax credits were at a tax disadvantage relative to corporations which had sufficient taxable income to use these benefits currently, certain corporations had an incentive to engage in tax benefit transfer mergers. See Tax Aspects of Mergers and Acquisitions at p. 5 and Report on Hostile Takeovers at p. 5.

Although Sec. 269 is one of the oldest statutory weapons available to the government (Sec. 269 of the 1986 Code originated as Sec. 129 of the 1939 Code) to prohibit tax-motivated mergers, the tax literature suggests it has proven particularly ineffective in preventing tax-motivated transactions. See Solinga, "A Survey of Legal Factors Helpful in Establishing the Principal Purpose Motivation Requirements of Section 269," 64 TAXES 302 (1986) and Weinstein, "Acquisitions Made to Evade or Avoid Income Tax--Section 269," Mertens Tax Highlights (November 1987) at 2-8.

The Senate Finance Committee has stated that the "principal purpose" language and the vagueness of Sec. 269 has rendered the provision effectively unadministrable. See Preliminary Staff Proposals at 43.

O'Connor notes that Sec. 279 has proven to be a "toothless tiger because knowledgeable practitioners can plan around it." See O'Connor, "The Tax Functions, Effects and Other Business Uses and Benefits of Debt Under the New Interest Deduction Rules and Tax Rates: Some Guideposts Through the Mazes of the Code" at 956.

25/In 1938, Sandberg raised the following tax policy issues which are surprisingly relevant in evaluating the acquisition proposals:

1. By allowing deferred recognition of realized gain at the target corporation and its shareholder/security holder levels, the existence of special tax rules for "tax-free reorganizations" is a nonneutral government economic policy which encourages certain types of corporate and shareholder transactions.

Sandberg, "The Income Tax Subsidy To 'Reorganizations'" at 100, 125.

Sandberg states:

> All of these speculations tend to the conclusion that, whatever the real purpose of the [tax-free reorganization] statutes, their actual effect is merely to encourage certain kinds of transactions but not others. Seen in this light, an entirely new set of questions arises. Why does the law discourage a 'sale' of corporate assets for short-term notes, but encourage an 'exchange' for long-term bonds? Why does it encourage an exchange of stock in a recapitalization, but discourage an exchange of bonds in a refunding operation? In all the reams which have been written about the aims of these statutes,

> there is no answer to such practical questions as these. Yet it is in these considerations and not in any esoteric definition of 'income' that their real implications are to be found.

Id., at 101-102.

2. The tax-free reorganization provisions deviate from the overriding tax policy that all realized gains should be immediately recognized. The tax-free reorganization provisions thus result in enormous tax expenditures. The arguments that an exception to this rule is justified because a reorganization involves a "rearrangement of corporate structures" and a "continuation of shareholder interests" and that taxing all realized gains immediately would "interfere with business operations and planning" are simply not valid.

Sandberg states:

> Their proponents [proponents of the tax-free reorganization provisions] have advanced two arguments which are a curious blend of the practical and the metaphysical. One was to levy a tax on the increment in value whenever the corporate form shifted would discourage 'necessary business adjustments.' The other was that these adjustments are transitional, 'continuing' transactions--rearrangements of participants in what is essentially the same organism. Although these arguments have a specious resemblance and are often used interchangeably, they are quite different. The first was the practical voice of businessmen who did not want income taxes to hinder the era of expansion and concentration which, in the early 'twenties, loomed just ahead. The second was a carryover to the halls of Congress of the quasi-legalisms which the Supreme Court had rejected. (emphasis added)
>
> The latter approach was unfortunate for two reasons: first, because the enactment of tax laws is a practical problem and governed by practical not doctrinaire considerations; second, because this conceptual explanation is not even verbally possible. (emphasis in the original)
>
> The [very first] Supreme Court cases did not involve mergers and consolidations. They were concerned only with changes within a single enterprise; and the argument advanced was that the enterprise or the stock interest was 'essentially the same' after the trans-

> action as it was before. But it seems hardly possible to apply this concept to combinations and regard a corporation resulting from a merger or consolidation as 'essentially the same' as each of the two corporations consolidated; or to regard the stock in the combination as 'essentially the same' as the stock in the component companies. Furthermore, after the extension of the provisions in 1924 to cover the gain of the corporation as well as that of its shareholders, the 'continuing transaction' idea became even less plausible, since the selling corporation usually distributed all the proceeds to its shareholders and ended up with no interest at all in the transferred assets. (emphasis in the original)

Id., at 99-100.

3. The detailed statutory tax-free provisions have not achieved their stated goals.

Sandberg states:

> When the [tax-free reorganization] statutes were first enacted, two other grounds for them were urged: (1) that they would dispel the uncertainty resulting from the [early] Supreme Court decisions; and (2) that by refusing to recognize loss on reorganization, they would increase the revenues. It is now generally admitted that the first use of these objectives has not been achieved and that there is at least as much uncertainty under the statutes as there was before them. The second advantage has not been gained either, for it is now clear that loss-producing transactions may easily be planned so as to fall outside the scope of the statutes.

Id., at 101.

26/Clark notes the complexity of the tax law now applicable to corporations and their shareholders approaches that of living organisms and that the perspective of a cultural anthropologist might successfully be employed to study Subchapter C issues and problems. See Clark, "The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform," 87 Yale L.J. 90 (1987).

In testimony before Congress on the Preliminary Staff Proposals, Donald Alexander, a former Commissioner of the Internal Revenue Service, stated that Subchapter C should be reformed because its provisions are seriously flawed, filled with inconsistencies and hidden opportunities for the well-advised, and significant tax traps for the ill-advised. See 1983 Hearings on Reform of Corporate Taxation at 129.

27/During the conglomerate merger era of the late 1960s, the Federal Trade Commission questioned the appropriateness of such a complex tax law for acquisitive transactions. See Report on Corporate Mergers (Bureau of Economics, Federal Trade Commission, 1969) at 2-74 through 2-91. The Treasury Department and Congress have periodically expressed their concern that the tax-free reorganization provisions need review and modification. In supporting the enactment of Sec. 368(a)(2)(E) (reverse subsidiary mergers), the Senate Finance Committee Report states:

> In discussion on this bill, the Treasury Department has expressed concern that the corporate reorganization provisions need review and modification. The Committee in agreeing to this amendment does not intend to foreclose consideration of any substantive changes which the Treasury may propose in the corporate reorganization provisions in any future presentations.

S. Rept. No. 91-1533, 91st Cong., 2nd Sess (1970).

Testa notes that in enacting the various triangular and reverse triangular merger provisions, Congress has not followed a consistent philosophy in allowing alternative means of structuring a tax-free merger of the acquiring and target corporations. See generally Testa, "The "A," "B," "C" Matrix of Triangular Reorganizations," 38 Inst. on Fed. Tax'n (1980) at 1-1. In commenting on the complexity of the reorganization definitions contained in Sec. 368(a)(1)(A)-(G), the 1982 ALI Study states: "The differences in requirements for reorganization status of different forms of subsidiary acquisitions are particularly difficult to grasp and impossible to justify." 1982 ALI Study at 27-28.

Posin notes that although providing federal income tax consequences for acquisitive transactions involves the same general issues as sales, exchanges, and other dispositions of property:

> . . . their application to the complex world of corporate acquisitions has proven to be an enormously complex task. For over half a century, Congress, the courts, and the Treasury Department have struggled to formulate a consistent and sensible approach to these

kinds of transactions.

Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1340. The general issues involved include:

1. determining if a gain or loss has been realized;

2. measuring the amount of the realized gain or loss;

3. determining if any of the realized gain or loss should be immediately recognized;

4. determining the income tax character of any recognized gain or loss; and

5. determining the cost and date basis of the corporate stock and securities, and other property received by the corporate and noncorporate parties to the transaction.

28/Ginsburg notes that the complexity of the tax law can sometimes result in the well-financed and well-advised being subject to a higher standard of behavior than those with less sophisticated or no tax counsel:

> Issues, at times, as obscure as they are vital, escape the notice of the unsophisticated practitioner, while the expert, perceiving them, invests disproportionate time and cost in search of a resolution and, too often finding none assured, must structure a commercially less advantageous transaction to achieve the desired tax result.

Ginsburg, "Taxing the Sale for Future Payment, A Proposal for Structural Reform, An Overview of Present Law," 30 Tax L. Rev. 469 (1975) at 475.

Another aspect of the possibility that bad tax laws drive out good tax practitioners or that unsophisticated tax practitioners will drive out the more sophisticated practitioners is that the tax laws in Subchapter C are so complex that they are often not applied. The nonapplication of the law leads to the ironic result that taxpayers can suffer economically by hiring sophisticated rather than unsophisticated tax advisers.

Roberts doubts that the Service can ever employ sufficient qualified personnel to enforce the existing laws applicable to corporations and their shareholders. Roberts states:

> To a considerable extent, the experience of the tax lawyer is that the tax law as written is simply not observed. This cannot be established statistically by those not privy to the information available to the Treasury and the Service; it must be conceded that this is merely the impression gained by experience. This conclusion, however, is the implicit assumption of those tax lawyers who believe the system will break down.
>
> Moreover, if the tax law were effectively and uniformly applied, it might well provoke a taxpayers' revolt that would dwarf those previously predicted, suggesting that the complexity of the present law is tolerated because the law is not enforced.
>
> Where tax lawyers are in a position to advise, with some degree of certainty, of the adverse tax consequences of a transaction, they can discourage many clients from consummating a transaction that is contrary to the law and, in the case of a consummated transaction, they can generally convince them to report the transaction on the tax return in a way consistent with a reasonably certain interpretation of the law. If the law is not clear, the tax lawyer is often in a weaker position to accomplish compliance. This denigration of the practice of tax law will also have an important effect on future generations of tax lawyers.

Roberts, "Simplification Symposium Overview: The Viewpoint of The Tax Lawyer," 34 Tax L. Rev. 5 (1978) at 11-13.

29/In commenting on the complexity and potential economic inefficiency of the tax-free reorganization provisions, Bittker and Eustice state:

> Because the stakes are often very high and the sources of conflict among taxpayers and between them and the government are so numerous, almost all reorganization exchanges involving the shareholders of publicly held corporations, and many private transactions as well, are conditioned on a favorable ruling by the Service unless the exchange falls in a simple and well-worn pattern. For this reason, the legal form or business bargain is often adjusted to eliminate questions that will be decided by the Service or--equally important--that it will not answer under its current policy. Rarely do the participants deliberately invite a test of strength in the courts,

> even if they feel a good deal of confidence in the outcome. As a result, the Service can make 'law' in this area by an uplifted eyebrow. It follows that the practitioner must not only examine with care the statute, regulations, decisions, and published rulings relating to a proposed transaction, but must also determine the informal administrative climate with respect to it.

Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (Warren, Gorham & Lamont, Inc., 4th Ed., 1979) at 14-7.

30/The 1986 Code may be horizontally inequitable because similarly situated corporate taxpayers and their shareholders may not, as a practical matter, have equal access to the effectively elective provisions of Subchapter C due to availability of financing or the ability to hire sophisticated tax counsel who can utilize the complex interactions of the categorical distinctions between taxable and carryover basis transactions and the necessary legal form of the transaction to achieve the taxpayer's tax and nontax objectives. Although well-financed and well-advised taxpayers can often accomplish desired tax consequences by manipulating the form of acquisitive transactions, forming holding companies, delaying execution of the transaction, etc., other taxpayers may not have the necessary financing and or may otherwise not be able to gain access to skilled tax counsel. In addition, in order to achieve a nontax goal (e.g., limiting the acquiring corporation's exposure to the liabilities of the target corporation), an acquisitive transaction may have to be structured in a suboptimal commercial fashion.

A casebook frequently used in law schools identifies several biases in the law which may work to the disadvantage of taxpayers unable to pay for sophisticated tax counsel:

> These [tax-free] reorganization sections are written against a background of normal business transactions. They are stated in terms of specific rules which chart a tax-free corridor though which may flow the corporate transactions intended to be so favored. But the very breath of the transactions to which the rules could extend and the mechanical terms in which they are written combine to make that corridor a tempting avenue of tax avoidance to persons who were not intended to be recipients of such a safe-conduct pass. This is especially true in the case of closely-held family corporations where the corporation may

> be readily manipulated by the shareholders. From the very beginning the courts, promoted by the Commissioner, have undertaken the task of policing this tax-free corridor. Their guarding has been vigorous and diligent, and many a corporation or shareholder who presented a pass carefully prepared to match the literal language of the sections has nevertheless been denied entrance.
>
> . . . Anyone applying for passage through the corridor runs the risk of the judicial policeman inventing a new rule on the spot if he thinks such action is demanded. . . . It must be remembered that most of the taxpayers who thus prompt administrative and judicial ingenuity have no real business in the corridor. But when such trespassers are in the throng, the barriers designed to separate them may catch an innocent, or may force the innocent to take added precautions to identify himself.

Surrey, Warren, McDaniel, and Ault, <u>Federal Income Taxation</u> (Cases and Materials Vol. II) (Foundation Press Inc., 1980) at 665-666.

In commenting on the fact that the 1954 Code provisions governing acquisitive transactions are effectively elective, Ginsburg states:

> Subchapter C is an elective taxing regime, and it works best when the elections are made by checking a box and not by exquisitely tailoring corporate investments.
>
> Elections are inevitably complicating. They can, nonetheless, lead to overall substantive simplification if the elections mechanism is straightforward and readily comprehended, the ability to choose aids commercial practice, and none of the available choices is inconsistent with sensible tax policy. . . . Experienced tax lawyers representing larger corporations handle transactional elections well. Otherwise competent general practitioners, regularly the advisers to smaller, closely held corporations, [often] do not know an [statutory] election is available.

Ginsburg, "Taxing Corporate Acquisitions" at 196.

Jacobs agrees:

> In a very real sense, for at least the last 20 years,

> and probably long before that, sophisticated tax planners have been able to achieve what is, in effect, elective tax treatment for acquisitive transactions.

Jacobs, "Reorganizing the Reorganization Provisions" at 418-419.

As discussed in more detail in Chapter IV of this Study, Shaw favors the enactment of the acquisition proposals primarily because they will simplify the tax law and allow smaller corporations and their owners more equal access to the tax-deferred provisions. See generally Shaw, "Impact of Proposals on Acquisitions Of Closely Held Corporations."

Not all commentators agree that making the corporate level tax consequences of acquisitive transactions is appropriate. Calvert and Erickson, for example, state:

> Current legislative proposals abandon the continuity [of interest] requirement. Instead, the taxpayer would elect the desired tax treatment rather than use the form of the transaction to select the desired tax treatment. While the current continuity of shareholder interest requirement may appear difficult to apply, using an election form to select tax treatment is not tax simplification.

Calvert and Erickson, "How to meet the continuity of interest test for reorganizations," 35 Tax'n for Acct. 358 (1985) at 362.

31/The American Institute of Certified Public Accountants (AICPA) states that tax laws are not neutral (i.e., similarly situated taxpayers are treated differently for tax purposes or the same tax treatment is accorded taxpayers who are not similarly situated) and are economically inefficient if economic reasoning clearly urges a particular acquisitive transaction to be structured in a specific form but the tax implications force the parties to use another, less efficient, form in order to secure the benefits of nonrecognition of gain treatment. See American Institute of Certified Public Accountants, Statement of Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises at 5.

The AICPA states:

> For example, the business the acquiring corporation wishes to purchase may have significant contingent

> or inchoate liabilities whose potential impact is completely unknown at the time of the purchase. In such a case, the purchaser in a stock-for-stock acquisition runs the risk that it may be overpaying for the acquired corporation's stock. Alternatively, in a statutory merger or consolidation, the acquiring corporation itself usually becomes liable automatically for all of the acquired corporation's known, unknown, or contingent liabilities.
>
> Thus, where the contingent liabilities of the acquired corporation are great (or the probability of unknown liabilities is high), the purchaser in a tax-free world might prefer a stock-for-asset exchange and thereby acquire only those debts it is willing to assume. However, the disparate tax treatment of these alternative methods of acquisition could, under some circumstances, force the purchaser to use one of the less efficient forms in order to achieve the overriding objective of nontaxability.

_Id_. The possibility that the acquisition provisions contained in the 1954 Code are not neutral and can lead to economic inefficiency are also discussed in Committee on Corporate Shareholder Relationships, "Tax Section Recommendation No. 1981-5," 34 _Tax Law_. 1386 (1981) and ABA Section of Taxation Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock," 37 _Tax Law_. 625 (1984).

32/Aside from the many unresolved overlaps between "taxable" and "carryover basis" transactions, there are many unresolved overlaps between the tax-free incorporation provisions of Sec. 351 and the tax-free reorganization provisions. Several practitioners have suggested that under the 1954 Code, the acquiring corporation and the shareholders of the target corporation desiring nonrecognition treatment create a preliminary holding company under Sec. 351. Thereafter the remaining shareholders of the target corporation can be "bought out" for cash, securities, or nonvoting stock issued by the acquiring corporation. If these transactions do not cause the overall transaction to violate the provisions of Sec. 351, the tax planner could obtain more flexibility in structuring an acquisition than is normally possible in the traditional tax-free reorganization defined in Sec. 368(a)(1).

These issues are discussed in Greenberg, "The Use of Holding Companies to Obtain Tax Advantages," 57 _TAXES_ 847 (1979) and Freeman, "Holding Companies: Section 351 as a Lever to Avoid Restrictions Inherent in Section 368, Section 301, and Sections 304 and 306," 6 J. Corp. Tax'n 32 (1980).

The Service rejected the above described use of Sec. 351 in Rev. Rul. 80-284, 1980-2 CB 117, and Rev. Rul. 80-285, 1980-2 CB 119. These two rulings are discussed in Rosenberg, "Use of Section 351 by Minority Shareholders in Acquisitions Challenged by New Rulings," 54 J. Tax'n 76 (1981); Silverman, "Comment: The Nonrecognition Sieve," 36 Tax L. Rev. 557 (1981); Bowen, "The Reach of Section 351," 59 TAXES 926 (1981); and Samuels, "The Limited Role of Section 351 in Corporate Acquisitions," 60 TAXES 955 (1982).

Subsequently, Rev. Rul. 84-71, 1984-1 CB 106, revoked Rev. Ruls. 80-284 and 80-285 and held that if the transaction fits Sec. 351, Sec. 351 will govern even though the Sec. 351 transaction is part of a larger acquisition that would not qualify as a tax-free reorganization under Sec. 368.

The Subchapter C Revision Act (in Proposed Sec. 351(a)(1)) would reverse the position of Rev. Rul. 84-71 and make the rules for qualified acquisitions, instead of those applicable to tax-free incorporations, govern these types of transactions.

33/See generally Zolt, "Corporate Taxation After The Tax Reform Act Of 1986: A State Of Disequilibrium," 66 N.C.L. Rev. 839 (1988).

Plumb and other commentators state that some of the fundamental and apparently well-understood concepts in the Internal Revenue Code have never been settled in reported court decisions. In addition, certain provisions of Subchapter C (e.g., Secs. 305 and 341), are so poorly drafted that they are virtually impossible to understand and apply. See Roberts, "Simplification Symposium Overview: The Viewpoint of the Tax Lawyer" at 17-18, 22-23.

Plumb notes that these factors cause tax practitioners to spend too much time on tax research and speculation about how the Service may rule in important areas of Subchapter C. Plumb notes:

> It is my conviction, however, that if a fraction of the time and energy that has been and will be devoted to distinguishing the undistinguishable, in countless litigated and audited cases and in the regulations-to-be, were directed instead to resolving the basic questions of tax policy, solutions would be found that would result in a more equitable tax system.

(emphasis added)

Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax L. Rev. 369 (1971) at 640.

34/See Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium." As discussed in more detail in Chapter IV of this Study, the repeal of the corporate level nonrecognition provisions based on the General Utilities doctrine without making the other changes contemplated by the Act, the elimination of the special tax rates for long-term capital gains of both corporate and individual taxpayers, and the general reduction in tax rates for both corporate and individual taxpayer which did much to informally integrate the corporate and shareholder level taxes, has upset the rough equilibrium and compensating biases in the 1954 Code. Zolt states the Revenue Act of 1987 further exacerbated the disequilibrium caused by the Tax Reform Act of 1986. Id., at 875-876.

35/The tax literature suggests that one of the problems of effecting comprehensive tax reform is that Congress enacts very complex and technical tax legislation (particularly tax expenditure provisions) within short periods of time with little or no regard for the administrative problems the legislation will cause for the Internal Revenue Service. See Simon, "The Budget Process And The Tax Law," 40 Tax Notes 627 (August 8, 1989); Steuerle, Who Should Pay For Collecting Taxes? Financing the IRS (American Enterprise Institute for Public Policy Research, 1986); and "Special Analysis G: The Fiscal 1990 Tax Expenditure Budget," 42 Tax Notes 347 (January 16, 1989).

In his study of how the Internal Revenue Service functions, Steuerle concludes:

(1) The benefits and costs of tax administration are often not adequately considered when Congress enacts tax legislation, particularly tax expenditure provisions. Congressmen become involved in the political struggle and either forget or overlook potential administrative problems when complex legislation is enacted. For example in the major tax reform effort of 1974 through 1976, each political compromise lead to the greater use of a minimum tax and passive loss limitations even though the tax writing committees of Congress were well aware that a more direct approach would have created far less administrative burden.

Steuerle, Who Should Pay For Collecting Taxes? Financing the IRS at 2-3.

(2) Increased complexity of the tax law and the frequency of change in the tax law does much to account for the increased complexity of administering the tax laws. Frequent changes in the Code often delay the issuance of regulations which results in substantial uncertainty for taxpayers and their advisers.

Id., at 7-9.

(3) Congress often does not understand or appreciate the economic and psychological benefits of spending money to make taxpayers comply with the tax law more closely.

Id., at 33-34.

(4) With few exceptions, the Internal Revenue Service is organized along functional (i.e., examination, returns processing, taxpayer service, etc.) rather than tax policy lines. This organizational structure does little to help either Congress or the Internal Revenue Service evaluate the administerability of the tax laws and the important relationship between formulating and implementing tax policies.

Id., at 38-39.

(5) Instead of increasing the amount of money, computers, personnel, and other resources available to the Internal Revenue Service, Congress would be much better served by evaluating proposed tax legislation by the administerability of the changes. Steuerle states:

> An administrative agency's functions are determined primarily by the laws it is assigned to enforce. When enforcement questions are large, the policies themselves must be called into question. A given policy may be meritorious from every standpoint except that it is difficult or expensive to administer; in that case it may still be poor policy.
>
> Over the years, government policies continually have been added to the Internal Revenue Code. Many are designed for worthwhile purposes: to promote investment, to encourage saving, to expand the availability of health care, to finance elections, to provide an incentive for the support of children, and so forth. The implementation of all these policies has been

> assigned to the IRS, almost always with little consideration of their administrative implications and with no additional funding provided to cover costs.
>
> Although the IRS is often criticized for its failures, Congress compliments the agency indirectly each time another tax deduction or credit is enacted. In effect, putting so much social policy into the tax code often reflects an implicit belief that the IRS has extraordinary administrative capacity, or at least more capacity than direct expenditure agencies that could be assigned to perform the same functions.

Id., at 38.

36/In testimony on the Preliminary Staff Proposals, a representative of Deloitte Haskins and Sells stated the firm's opposition to the complete elimination of the continuity of interest and continuity of business enterprise doctrines because this would do much to move the tax law away from traditional notions of what distinguishes tax-free reorganizations and sales. The representative noted that problems with the administration of these concepts has been the lack of a consistent and rational statutory definitions of "tax-free reorganizations" rather than with the principles which have historically been used to distinguish sales and tax-free reorganizations. See 1985 Hearings on Reform of Corporate Taxation at 459.

37/Under current law, the judicial requirement of continuity of interest requires the target shareholders to maintain such a continuity of interest in order for an acquisitive transaction to be treated as a tax-free reorganization. This requirement may implement poor tax policy because (1) it links the actions of the corporation and the shareholders in order for the overall transaction to constitute a "tax-free reorganization" and (2) the differing quantitative standards for determining whether the target shareholder have the requisite continuity of proprietary interest in the acquiring corporation leads to uncertainty and the lack of predictability of tax consequences.

If a majority of the shareholders of the target corporation dispose of the acquiring corporation stock received in the exchanges of stock incident to the purported reorganization, the overall transaction may not constitute a tax-free reorganization because of the lack of continuity of interest. Advocates of the acquisition proposals point out the potential inequitable treatment to an acquiring corporation which desires tax-free reorganization treatment but cannot control the actions of the former shareholders of the target corporation.

The Service has a long-standing policy (currently reflected in Rev. Proc. 77-37, 1977-2 CB 568) that for advanced ruling purposes, the continuity of interest requirement will be satisfied if the stock consideration received by the target shareholders, is, in the aggregate, at least fifty percent of the total value of the target corporation immediately prior to the reorganization. However, the courts have often taken a much more permissive view finding that the continuity of interest requirement was satisfied where only 38 percent of the total consideration paid by the acquiring corporation to the target was nonvoting preferred stock. See Nelson v. Helvering, 296 U.S. 374 (1935). See also Mary B. Kass, 60 TC 218 91973) (the Tax Court held that the continuity of interest requirement was satisfied where only 16 percent of the consideration received by the former shareholders of the target corporation consisted of stock issued by the acquiring corporation) and Yoc Heating Corporation, 61 TC 168 (1973) (the Tax Court held the continuity of interest requirement was not satisfied where only 15 percent of the consideration received by the former shareholders of the target corporation consisted of stock issued by the acquiring corporation).

Advocates of the acquisition proposals argue that the conflicting administrative and judicial interpretations of the long-standing continuity of interest requirement creates needless costs and complexities in the tax-free reorganization area of the law and does little to promote certainty or predictability.

38/Under current law, the judicial requirement of continuity of business enterprise requires the acquiring corporation to continue the business of the target corporation (or to use the target's assets in its business) in order for an acquisitive transaction to be treated as a tax-free reorganization. As is the case for the continuity of interest requirement, the appropriateness of the continuity of business enterprise requirement has been questioned from a tax policy perspective. Advocates of the acquisition proposals point out the potential inequities of denying desired tax-free reorganization treatment to the shareholders and security holders of the target corporation because the acquiring corporation does not continue the business of the target or use the target's assets is its business, particularly when the target shareholders and security holders cannot control the actions of the acquiring corporation.

The tax literature suggests some additional problems. The continuity of business enterprise requirement, as expressed in Regs. 1.368-1(d) ex.(5) states that if the acquiring corporation immediately disposes of the target's assets as part of the plan of reorganization, the entire transaction will not constitute a tax-free reorganization due to lack of continuity of business enterprise. Because the plan of reorganization can be an informal plan, Libin questions how the acquiring corporation is to document whether the disposition of assets acquired from the target is or is not "part of the plan of reorganization." Libin and Bloom also note that the linkage of the desired shareholder tax consequences (e.g., tax-free reorganization treatment) to the post-transaction actions of the acquiring corporation can create a conflict of interest between the acquiring corporation and the target shareholders. The acquiring corporation generally prefers a taxable transaction in order to obtain a tax basis in the assets acquired form the target which reflects its investment. Thus the acquiring corporation may be tempted to intentionally fail the continuity of business enterprise requirement and, in turn, obtain taxable treatment, rather than tax-free reorganization treatment, in order to take a stepped-up, rather than a carryover, basis in the assets acquired from the target. If this occurs, the overall transaction cannot constitute a tax-free reorganization and the target shareholders cannot utilize the deferred recognition provisions of Secs. 354 and 356 and the substituted basis provisions of Sec. 358. See Libin, "Continuity of Business Enterprise: The New Regulations" at 4-18 and Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 335.

Bloom notes the possibility of conflicts between the acquiring corporation and the shareholder of the target corporation, the administrative difficulties, and the possibility of the government being whipsawed by taxpayers taking mutually inconsistent positions:

> Where the acquiring corporation can unilaterally change the tax consequences of a reorganization unbeknownst to, and without the consent of, the acquired corporation shareholders, great difficulties in the administration of the tax laws develop. Acquisition of assets in a merger, followed by discontinuance of acquired business functions by the acquiring corporation to intentionally avoid continuity of business enterprise will become very tempting to the acquiring corporation where there is not a need to maintain harmonious relations with the

> acquired corporation's shareholders via employment agreements or contingent stock plans. The desirability will be enhanced if the issue of increase in basis arises after the statute of limitations has expired for assessing a shareholder deficiency.

Id., at 336.

By eliminating the continuity of business enterprise requirement as a prerequisite for qualified acquisition status, the acquisition proposals do much to sever the linkage of corporate and shareholder actions and tax consequences and the possibility of whipsaw.

39/See generally Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" noting that most acquisitive transactions structured as tax-free acquisitive reorganizations involve the sale of a corporate business rather than the "restructuring" of the corporation envisioned by the early statutory provisions and judicial decisions.

40/The fact that the Service and the courts have used the judicial requirements for tax-free reorganization treatment inconsistently across taxpayers has been severely criticized in the tax literature. See, e.g., Zelenak, "Should Courts Require the Internal Revenue Service to be Consistent?" 38 Tax L. Rev. 411 (1985).

Taxpayers have been singularly unsuccessful when they have argued that a transaction should not be accorded tax-free reorganization status (or other mandatory treatment) because it failed to comply with one of the judicial doctrines (or other judicial requirements). See Holzman, Tax-Free Reorganizations at 396.

For example, in Rochester H. Rogers Estate, TC Memo 1972-192 (1970), the court stated:

> The so-called 'two-way street' seems to run downhill for the Commissioner and uphill for the taxpayer. The Commissioner must be permitted to go beyond the mere form to the substance in order to protect the revenue; but taxpayers have the opportunity at the outset to choose the most advantageous arrangement.

Michaelson states the courts created and expanded the business purpose doctrine because taxpayers and their advisers were too successful in using the early tax-free reorganization provisions to avoid taxes. See Michaelson, "'Business Purpose' and Tax-Free Reorganizations" at 20.

Michaelson notes that as the business purpose doctrine as created in Gregory v. Helvering, 293 U.S. 464 (1935), developed and became an accepted prerequisite for tax-free reorganization treatment, commentators became virtually unanimous in lamenting the judicial mysticism required to determine if the requisite business purpose existed.

Michaelson argues much of this criticism is misplaced; the judicial requirements for tax-free reorganizations are "Commissioner's weapons" which were never intended to be applied consistently across similarly situated taxpayers. In addition, the Commissioner should be allowed flexibility because the taxpayer is initially in command of the situation. Michaelson states:

> It is an open secret that business purposes are often manufactured in the offices of attorneys. And it is from the taxpayer that proof of the purposes must come. Taxpayers should be allowed to benefit from the option of producing or failing to produce documentation of sufficient purpose.

Michaelson, "'Business Purpose' and Tax-Free Reorganizations" at 25.

41/In considering the Revenue Act of 1934, a subcommittee on the House Ways and Means Committee strongly urged the total repeal of all definitional and operative sections of the tax law applicable to tax-free reorganizations. The principal arguments for repeal included:

(1) The reorganization provisions cost the federal government about $18,000,000 annually through avoidance of the income tax which would have otherwise been levied on the gains realized by the corporate and noncorporate participants in reorganizations.

(2) Experience had clearly demonstrated the provisions were intricate, hard to interpret, and difficult to administer.

Prelim. Rept. of the Subcomm. on Ways and Means, Prevention of Tax Avoidance, 73rd Cong., 2nd Sess. (1934) and Sandberg, "Income Tax Subsidy to 'Reorganizations'" at 120.

Given the economic condition of the United States in 1934, the Treasury Department opposed the repeal of all special income tax provisions applicable to tax-free reorganizations. The principal arguments for retaining the reorganization provisions included:

(1) Although there was little question that the statutory provisions had been used for tax avoidance purposes in the past, a redrafting in more general terms would allow the Treasury Department and the courts to determine all such uses in the future.

(2) Total repeal of the reorganization provisions would result in a significant loss of tax revenue to the federal government.

Statement of Acting Sec. of the Treasury Regarding the Prelim. Rept. of a Subcomm. of the Ways and Means Comm., 73rd Cong., 2nd Sess. (1934). See also Sandberg, "Income Tax Subsidy to 'Reorganizations'" at 120-122.

Spear notes the Committee Reports on the Revenue Act of 1934 give no indication of Congressional approval or disapproval of a business purpose requirement as a prerequisite for transactions to be treated as tax-free reorganizations. See Spear, "'Corporate Business Purpose' in Reorganizations" at 232.

42/In enacting the 1954 Code, Congress rejected proposals by the House of Representatives to make the following major tax policy changes in the tax-free reorganization provisions of the 1939 Code:

(1) The House bill would have abandoned the approach and substance of the 1939 Code (which, as discussed in the text and the Appendix, is very similar to that of the 1986 Code) and would have radically altered the then current statutory and judicial concepts of a "reorganization." The House bill would have eliminated the term "reorganization" and would have determined the tax consequences of the exchanges incident to a reorganization as if such "adjustments" represented distributions to shareholders, rather than as exchange transactions.

See Sec. 359 of H.R. 8300, 83rd Cong., 2nd Sess. (1954) at A1342 and H.R. Rept. No. 1337, 83rd Cong., 2nd Sess. (1954) at A115. The House bill would also have altered the corporate and shareholder/security level concepts of the 1939 Code by abandoning the concepts of "exchange," "party to the reorganization," and "plan of reorganization."

(2) Consistent with the notion that exchanges in connection with reorganizations are corporate distri-

butions, the House bill provided for three basic types of acquisitive transactions which could have been conducted on a tax-free basis: corporate acquisitions of stock; corporate acquisitions of property; and corporate separations.

See Secs. 359(c) and 359(d) of H.R. 8300, 83rd Cong., 2nd Sess. (1954).

(3) The House bill would have drastically limited the use of statutory mergers and consolidations as a tax-free acquisitive technique because neither mergers nor consolidations would constitute a tax-free transaction unless they were a corporate acquisition of property.

See Secs. 359(a), 359(b), and 359(c)(1) of H.R. 8300, 83rd Cong., 2nd Sess. (1954).

(4) The House bill would have drawn a distinction between publicly-held and other corporations and allowed corporate level nonrecognition of gains and losses realized as a result of exchanges incident to a reorganization only for publicly-held corporations.

See Secs. 359 H.R. 8300, 83rd Cong., 2nd Sess. (1954) and H.R. Rept. 8300, 83rd Cong., 2nd Sess. (1954) at A 132.

(5) The House bill would have allowed the target corporation to receive an unlimited amount of cash or other boot in the exchanges incident to a reorganization. The "price" to be paid for this relaxation of the amount of nonstock consideration was the new requirement that the target undergo a complete liquidation pursuant to the plan of reorganization. In this manner, the boot received by the shareholders of the target would be immediately taxable to the extent of gain realized by such shareholders upon receipt of liquidating distributions.

See Secs. 354(a) and 359(a) of H.R. 8300, 83rd Cong., 2nd Sess. (1954).

43/The Senate Finance Comm. generally agreed with the House's conclusion that the reorganization provisions of the 1939 Code caused uncertainty and needed major revision. See S. Rept. No. 1662, 83rd Cong., 2nd Sess. (1954) at 265 and Conference Comm. Rept. on H.R. 8300 in H.R. Rept. No. 2543, 83rd Cong., 2nd Sess. (1954) at 34. Because of the differences in the tax treatment of publicly-held and other corporations and the limited time available to study the extensive changes and the extensive criticisms of them by the business community, the Senate found it easy to oppose the House bill. See Hrgs. on the Comm. on Finance on H.R. 8300 (1954) at 533-559. The 1954 proposals are discussed in Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions and Dispositions: Substance and Process" at 17-33.

44/Leduc, for example, praises the process by which the Preliminary Staff Proposals were prepared and subjected to Congressional hearings. Leduc describes the process as unusually open and one which provided a balanced discussion of the major arguments for and against each of the acquisition proposals. See Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions and Dispositions: Substance and Process" at 34.

In the hearings on the final acquisition proposals, Senator John Chaffe, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, noted the tax reform proposals contained in the Subchapter C Revision Act were probably the slowest moving and most studied tax legislation project before Congress in some time. Chaffe suggested that the Committee on Finance should not "study a project to death" and "must differentiate between those who really believe more study is necessary [before moving ahead with the Act] and those who just don't like the proposals." Chaffe recommended that the Committee on Finance should decide whether the Act would improve Subchapter C and act accordingly. See 1985 Hearings on Reform of Corporate Taxation at 80-81.

45/Sandberg, "The Income Tax Subsidy to 'Reorganizations'" at 98.

46/See generally Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution," 37 Tax Notes (October 27, 1987) at 417. Yin notes when Congress codified the General Utilities doctrine in the 1954 Code by enacting the complete liquidation rules and Sec. 334(b)(2), the predecessor of Sec. 338, inadequate attention was given to fact that these rules exacerbated the tax differences between acquisitions of target corporation assets and target corporation stock.

47/United States Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: Volume 1--Overview; Volume 2--General Explanation; and Volume 3--Value Added Tax (November 1984) (hereafter Treasury I).

48/United States Government Printing Office, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) (hereafter Treasury II).

49/Treasury I, Vol. II, at 144.

50/Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (Warren Gorham & Lamont, Inc., 4th Ed., 1979) at 14-6 and 14-7.

51/The 1954 Code rewarded taxable acquisitions and penalized carryover basis acquistions on a present value basis. Unless the target corporation has net operating loss carryforwards, the 1986 Code rewards carryover basis acquisitions and penalizes taxable acquisitions on a present value basis. Most commentators regard this reversal as a symptom that Congress has not addressed the basic tax policy problem of conforming the tax consequences of stock and asset acquisitions.

Under the 1954 Code, many of the discontinuities between stock and asset acquistions were caused by the corporate level nonrecognition provisions of the 1954 Code which were based on the now repealed General Utilities doctrine. The corporate level nonrecognition provisions created a bias in favor of liquidating sales and Sec. 338 transactions and against carryover basis transactions on a present value basis. Under the 1954 Code, the shareholders or the acquiring corporation could obtain a stepped-up basis in the assets of the target corporation without a full recognition of gain realized by the target. In a tax-free reorganization, the acquiring corporation had to take a carryover basis in the target's assets but the target corporation generally did not recognize gain and its shareholders and security holders had to recognize gain only if they received boot. As a general rule, liquidating sales under Sec. 337 and stock acquisitions treated as acquisitions of assets by statutory election under Sec. 338 were favored over tax-free reorganizations because the present value of the tax benefits of the stepped-up basis exceeded the present value of the tax cost of taking assets out of the target corporation in a taxable transaction. See Subchapter C Revision Act at 42-44.

Under the 1986 Code, the relative advantages of taxable transactions (e.g., liquidating sales and Sec. 338 transactions) and carryover basis transactions (e.g., purchases of corporate stock and tax-free reorganizations) are reversed on a present value basis. The repeal of the General Utilities doctrine causes the target corporation to recognize all appreciation in assets if a Sec. 338 election is made, if the assets are sold to the acquiring corporation, or if the appreciated assets are distributed on an in-kind basis to its shareholders. The Tax Reform Act of 1986 made no fundamental changes in the tax-free reorganization provisions. Thus an acquisition structured as a tax-free reorganization will avoid the recognition of gain at the target corporation level and at the shareholder/security holder level (if no boot is received) but the acquiring corporation must take a carryover basis in the assets of the target corporation. As a general rule, carryover basis transactions are favored over taxable transactions on a present value basis because the present value of tax benefits obtained from the stepped-up in basis of the target's assets are less than the present value of the immediate tax cost of obtaining the step up.

As will be discussed in Chapter IV of this Study, most commentators agree that the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 without making the other changes recommended in the Act is incomplete tax reform. See, e.g., Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform" and Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium." Tax planning issues and problems are discussed and illustrated in Kotlarsky, "Stepping Up Basis: Purchase Of Stock Or Purchase Of Assets," 39 Tax Notes 1101 (May 30, 1988) and Unger, "Gain Recognition and Basis in Acquisitions," 45 Inst. on Fed. Tax'n (1987) at 3-1.

All commentators agree that the repeal of the General Utilities doctrine has exacerbated the differences between what are often economically similar acquisitions of the assets or the stock of the target corporation. See, e.g., Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics Not Being Basic," 14 J. Corp. Tax'n; Roche, Myers and Zucker, "Price Allocation on Acquisitions and Basis Step-Up: Tilting at Windmills?" 65 TAXES 833 (1987); Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution"; and Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986," 42 Tax L. Rev. 575 (1987).

52/Preliminary Staff Proposals at 3-4. As was the case for the 1982 ALI Study (see 1982 ALI Study at 2), the Preliminary Staff Proposals were based on the following assumptions: (1) A corporate income tax would continue to be imposed. (2) Capital gains would be taxed at a substantially lower rate than ordinary income. (3) The ability of corporations and shareholders to restructure their continuing corporate investments on a tax-free basis is important in order that the tax law not unnecessarily burden the flow of capital into the most productive investments. An exception to the general rule that all realized gains be recognized should be provided to prevent investors from being locked into the form of their investment. The sale by shareholders of corporate stock would be permitted without requiring the corporation to recognize gain. In certain corporate combinations, gain would not be recognized to shareholders who only receive stock. The tax law should be entirely neutral among combinations, purchases and divestitures of business enterprises. The tax law should neither encourage nor discourage such transactions. (4) Stockholders would be entitled to a step-up in basis of stock held at death.

The Tax Reform Act of 1986 provides that both long-term capital gains and ordinary income will be taxed at the same rates. See Simmons, "The Tax Reform Act of 1986: An Overview," 1 B.Y.U.L. Rev. 151 (1987).

53/Subchapter C Revision Act at 37.

54/David Brockway, former Chief of Staff of the Joint Committee on Taxation, observes the federal income tax law becomes more complex in response to the increasing complexity of the economy. Brockway also admits the use of the tax laws to accomplish a variety of nontax policy goals has led to an economically inefficient tax system. Brockway agrees that the increased complexity and incoherency of the 1954 Code necessitates some attempt at comprehensive tax reform. "Comment: The Process Behind Successful Tax Reform," 31 Vill. L. Rev. 1803 (1986).

55/The AICPA states:

> . . . where public policy dictates that the interests of society are best served by preventing, limiting, or retroactively remedying a particular corporate acquisition or merger, the laws, regulations, and sanctions employed to accomplish these objectives should arise solely from sources outside the tax law. (emphasis added)

AICPA, Statement of Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises at 4.

Eustice states that public policy makers have used the tax laws too frequently to solve what are fundamentally nontax problems:

> The tax law is increasingly thought to be a solution

> for practically every social or economic problem that the mind of man can imagine. Surely there must be limits to what this structure can carry. It seems that peripheral areas of the tax system have gone too far a field from [its] basic goals . . . , and this has done much to farther the . . . problems now plaguing the system.

Eustice, "Tax Complexity and the Tax Practitioner," 44 Calif. CPA Q. 10 (1987) at 12.

56/See generally Volpi, "Availability of the installment method is limited after tax reform."

57/See n. 24 supra for a discussion of transactions (e.g., churning mergers) designed to exploit the lack of symmetry between nonrecognition of gain by the target corporation and the ability of the acquiring corporation to take a fair market value basis for the target's assets.

58/Unless Congress acts to conform the tax consequences of asset and stock acquisitions, some commentators agree that the next best solution is to allow explicit electivity of the corporate level consequences of acquisitive transactions by directly linking the issues of acquiring corporation bases for target assets or stock and recognition or nonrecognition of gain to the target corporation. Thus neither the legal form of the transaction nor matters of corporate procedure would affect the tax consequences to the extent they do under the 1986 Code. The 1982 ALI Study states:

> Making electivity explicit would have a fundamental impact, however, on the relationship between tax consequences and corporate procedure--not mainly on what tax results can be achieved, but how. Election among permissible tax results under existing law must often be made by choosing a particular corporate procedure to which the desired tax consequences have been attached. A major effect of these proposals has been to make elections as independent as possible of choices of corporate procedure.

1982 ALI Study at 10.

59/A continuing problem in the tax law is that although the acquisition of the assets or the stock of the target corporation often have nearly identical economic consequences, these economically similar transactions continue to have much different tax consequences. Thus, in the opinion of many commentators, the legal form of the transaction and matters of corporate procedure can and do play too important a role in determining the tax consequences of acquisitive transactions and can cause different tax consequences for economically similar transactions. See, e.g., Subchapter C Revision Act at 45-46.

Under the 1986 Code, an acquisition of corporate stock is normally a carryover basis transaction whether done as a tax-free reorganization or as a simple purchase of target corporation stock. Such acquisitions of stock are not realization events at the target corporation level unless a Sec. 338 election is made. Unless an asset acquisition is structured as a tax-free reorganization, it is a taxable transaction at the target corporation level. If the target corporation undergoes a complete liquidation or distributes the sale proceeds to its shareholders, a nonreorganization asset acquisition is also a taxable transaction to the shareholders and security holders of the target corporation.

The manner in which the tax developed in the United States does much to account for the disparate treatment of asset and stock acquisitions. Except for the statutory election contained in Sec. 338, the tax law has consistently refused to treat the sale (or purchase) of a share of corporate stock as the sale (or purchase) of the underlying assets.

As discussed in more detail in Chapter IV of this Study, some commentators believe conforming the tax consequences of asset and stock acquisitions would do much to resolve many of the problems associated with the current tax law for acquisitive transactions and for transactions between parent corporations and their controlled subsidiaries. Yin, for example, argues that the tax law could achieve neutrality between asset and stock acquisitions by adopting either a mandatory Sec. 338 approach (in which the sale of corporate stock would be treated as the sale of the underlying assets which would trigger recognition of gain at the corporate level) or the elective carryover basis approach proposed in the acquisition proposals (in which the issues of acquiring corporation basis and recognition or nonrecognition of gain to the target are directly linked and controlled by an explicit election instead of the present system of transactional electivity, i.e., manipulating the legal form of the transaction and other matters of corporate procedure and complying with various judicial doctrines in order to obtain desired tax-free treatment). See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution."

Few commentators are optimistic that Congress will act to conform asset and stock acquisitions because the resolution of this problem involves some of the most fundamental tax policy issues (realization, recognition, consistency, etc.) in the federal income tax law.

60/See generally 1982 ALI Study at 54-58.

61/Several commentators question the assumption in the ALI Studies and the Act that the federal income taxation of acquisitive transactions can be meaningfully reformed absent movement to comprehensively reform Subchapter C in its entirety. As discussed in Chapter IV of this Study, the acquisition proposals have been criticized because they are narrow, technical, highly legalistic, and quite possibly revenue-losing solutions to some of the broadest and most complex income tax and public policy issues facing Congress in the 1980s.

The 1977 ALI study, for example, notes that if the shareholders of a corporation paid an annual income tax on the increase in value of their shares of stock in the corporation, no special definitional provisions would be necessary to distinguish sales and rearrangements of businesses, no special operative sections would be necessary to provide deferred recognition of gain through the basis rule for business rearrangements, and no special judicial requirements would be necessary to prevent abuse of the nonrecognition provisions. Under such a tax regime, the corporation would have no potential or conditional income tax liabilities at the end of each year which would require special tax treatment when an acquisitive transaction takes place. See 1977 ALI Study at 5.

For a discussion of whether comprehensive tax reform was achieved in the Tax Reform Act of 1986 see Minarik, "Individual Income Tax Issues As Revised By Tax Reform," XLI Nat'l Tax J. 291 (1988) (suggesting that many individual taxpayers have such a poor understanding of the federal income tax system that they cannot understand that the loss or limitations on tax deductions can be more than offset by a reduction in marginal tax rates) and McClure, "The 1986 Act: Tax Reform's Finest Hour Or Death Throes Of The Income Tax?" XLI Nat'l Tax J. 303 (1988) (arguing that the Tax Reform Act of 1986 illustrates the extreme administrative and other difficulties in moving the federal income tax law toward a pure income tax system--one that taxes all economic income in a uniform manner).

62/See Jacobs, "Reorganizing the Reorganization Provisions" at 418.

63/In virtually all situations, the present value of the tax cost to the target corporation in a taxable transaction (and, under the Act, in a QA for which a cost basis election has been made) will exceed the present value of the tax savings to the acquiring corporation because the target's tax liability must be paid immediately while the acquiring corporation's increased tax savings due to an increased basis will be realized over the tax life of the asset. See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal," 65 TAXES 819 (1987) and Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution."

64/Cummings notes that similar trade-offs of basis and gain recognition are allowed in Sec. 351 (tax-free incorporations), Secs. 721, 722, 723 (tax-free formations of partnerships), Sec. 1031 (like-kind exchanges), and the operative provisions and basis rules for tax-free reorganizations. Cummings also states:

> The tax cost basis doctrine is so deeply rooted in our [U.S.] tax law that it makes little sense to attempt to eradicate it in the context of corporate acquisitions where sections 332/337 [of the 1986 Code] reflect a policy of encouraging the simplification of corporate structures. That policy withstood attack in the Revenue Act of 1987.

Cummings, "More On The Yin-Shores Debate Over Carryover Basis Asset Acquisitions," 38 Tax Notes 293 (January 18, 1988).

65/The fact that the acquisition proposals have been criticized because they effectively expand the present tax-free reorganization treatment at the shareholder level by repealing the three judicial doctrines and effectively abandon the traditional concepts of how "tax-free reorganizations" differ from sales by allowing explicitly elective tax-free treatment at the target level for cash sales of its assets to the acquiring corporation is evidence that the acquisition proposals significantly liberalize the present law for acquisitive transactions. See generally Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions."

66/Those who believe there is a substantive difference between a taxable sale of corporate assets and tax-free reorganizations as historically developed (i.e., transactions in which the acquiring corporation continues the business of the target corporation and in which the former shareholders of the target corporation have a continuing equity interest in the acquiring corporation) which should be recognized for tax purposes note that the financial accounting concepts of accounting for business combinations as a "purchase" or a "pooling of interests" have long taken this position. See, e.g., Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisition and Dispositions" at 180.

67/These problems are most closely related to Proposal Two. The extensive body of tax law and tax literature on liquidation-reincorporation transactions (i.e., transactions in which taxpayers attempt to remove appreciated assets from one corporation (OLDCO) controlled by them and put the assets into another corporation (NEWCO) controlled by them in order to obtain a stepped-up basis without the full recognition of gain realized by OLDCO) is, in the view of some commentators, a primary example of why the judicial doctrines associated with tax-free reorganizations are needed to prevent tax abuse under the 1986 Code and may be needed for similar reasons under the elective taxing system proposed by the acquisition proposals.

Liquidation-reincorporation transactions and the attendant problems caused when the tax-free reorganization provisions are used to combat them are discussed in Schwartz, "Liquidation-Reincorporation: A Sensible Approach Consistent With Congressional Policy," 38 U. Miami L. Rev. 231 (1984); Bradley, "1984 TRA Gives IRS Stronger Weapon to Use in Liquidation-Reincorporation Transactions," 64 TAXES 261 (1986); Thorne, "Prompt action needed to obtain full benefits of liquidation followed by a reincorporation," 39 Tax'n for Acct. 338 (1987); and Westin, "In Like a Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse," 42 Tax Notes 997 (February 20, 1989).

68/1982 ALI Study at 10.

69/Knight and Knight, "Merger Mania: Did the Tax Reform Act of 1986 Reduce the Tax Incentives for Corporate Takeovers, Mergers, and Acquisitions?" at 85.

70/Id. See the Appendix for a discussion of the various ways in which tax practitioners attempted to avoid the repeal of the corporate level nonrecognition provisions which codified the General Utilities doctrine.

71/The Act states these doctrines should not serve as prerequisites for qualified acquisition treatment given the goals of unlinking the corporate and shareholder level tax consequences of a qualified acquisition and making the corporate level tax consequences explicitly elective. The Act also states these long-standing judicial doctrines have uncertain application and cause a number of tax planning problems because a great deal of uncertainty surrounds the exact parameters of these judicial requirements. See Subchapter C Revision Act at 40-41.

72/The acquisition proposals follow Jacobs' observation that in order to make any lasting tax reform of the tax-free reorganization provisions of the 1954 Code, the price one must pay for certainty and predictability is that "form [of the transaction] must be accorded an all but irrefutable presumption of governance." Jacobs, "Reorganizing the Reorganization Provisions" at 416.

73/Many commentators conclude there is one effectively elective tax law for well-financed and well-advised taxpayers and another essentially mandatory, and generally harsher, tax law for others. Some commentators agree that making the corporate level tax consequences of acquisitive transactions explicitly elective will make tax-free treatment more easily available to all taxpayers, particularly smaller and closely-held businesses. See, e.g., Shaw, "Impact Of Proposals On Acquisitions Of Closely Held Corporations." Shaw concludes that, on balance, the Act would be beneficial to closely held corporations because such corporations could more readily utilize the tax-free provisions of the Code. See also 1983 Hearings on Reform of Corporate Taxation at 205 (statement of Leon Nad, National Director of Technical Tax Services for Price Waterhouse).

In commenting on the acquisition proposals contained in the Act, Martin Ginsburg states:

> In sum, where we are is always where we seem to end up. One tax law for the well-advised. A different, substantially more oppressive tax law for those cursed with inadequate tax counsel and a notice of a federal tax audit.

Ginsburg, "Special Topics In The Acquisitions Area" at 160.

74/As noted, one of the overall goals of the Act is to consolidate, simplify, and make uniform the tax consequences for acquisitive transactions whether classified under the 1954 Code as tax-free reorganizations, liquidating sales under Sec. 337 (the 12-month complete liquidation provisions), or stock acquisitions treated as asset acquisitions under Sec. 338. Most commentators believed that repeal of the corporate level nonrecognition provisions based on the General Utilities doctrine was absolutely essential to accomplishing this goal. The Tax Reform Act of 1986 repealed the corporate level nonrecognition provisions contained in the 1954 Code without making the other changes recommended in the Act (including the enactment of the four acquisitions proposals).

As discussed in Chapter IV of this Study, the repeal of the General Utilities doctrine changes the necessity for the enactment of the acquisition proposals from a technical, tax policy, and perhaps most importantly, a political perspective. After all of the debate about the repeal of the General Utilities doctrine, it does not appear likely that Congress would enact the acquisition proposals under which cost basis elections would rarely be made because they cannot be economically justified on a present value basis (e.g., the present value of the tax cost to the target corporation will generally exceed the present value of the tax savings to the acquiring corporation). In addition, allowing corporations to elect a carryover basis acquisition in which the target corporation would not have to recognize gain even if the acquiring corporation used all cash consideration is contrary to the expansion of the corporate tax base evident in the 1986 Code To some extent, the effective expansion of the operative provisions for tax-free reorganizations to all qualified acquisitions would have the effect of repealing the repeal of General Utilities.

As discussed in Chapter IV of this Study, most commentators feel the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 greatly reduces the likelihood that the acquisition proposals will ever be enacted by Congress. Very few well-advised corporations will elect cost basis acquisitions for much the same reasons that taxable transactions are disadvantageous compared to carryover basis transactions under the 1986 Code on a present value basis. The elimination of the three judicial doctrines and the partial separation of the corporate and shareholder tax consequences of qualified acquisitions all suggest that enactment of the Act at this time would be a very complex revenue-loser. Enacting such revenue-losing proposals is not a high priority for the majority of politicians. See generally Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future," 46 Inst. on Fed. Tax'n (1988) at 37-1.

75/Advocates of the acquisition proposals believe allowing explicit electivity of corporate level tax consequences of qualified acquisitions will minimize differences in tax consequences caused by the legal form of the transaction and matters of corporate procedure. Allowing the acquiring corporation to obtain a cost basis (at the cost of recognition of gain realized by the target corporation) or carryover basis (with no gain realized) for the target's assets by checking a box on a tax return, instead of tailoring the legal form of the transaction to fit the categorical distinctions between liquidations, reorganizations, and Sec. 338 transactions found in the 1954 and 1986 Codes, is stated to have a number of benefits for the corporate and noncorporate parties involved.

As discussed supra, an important tax policy issue is whether the direct trade-off between the acquiring corporation taking a cost basis if the target corporation recognizes gain or a carryover basis if the target does not recognize gain is appropriate given the fact that in the post-General Utilities world, the present value of the immediate tax cost to the target for a cost basis election will generally exceed the present value of future tax benefits (e.g., increased depreciation and amortization deductions) to the acquiring corporation.

76/In a cost basis QA, the target corporation's tax liabilities will be settled because the target must recognize the gain or loss inherent in its assets as the date of the acquisition. The target corporation will pay these liabilities or the acquiring corporation will assume them in negotiating the transaction. In a carryover basis QA, the target's conditional and potential tax liabilities will, in effect, be assumed by the acquiring corporation because the acquiring corporation will take a carryover basis for the target's assets. In any event, the conditional and potential tax liability of the target can be dealt with explicitly rather than having to manipulate the legal form of the transaction. See 1981 ALI Study at 13.

77/The philosophy of the 1954 Code provisions for acquisitive transactions is summarized in Faber, "Taxation Of Corporations And Shareholders: Premises of The Present System."

78/A detailed discussion of the statutory and judicial conceptions of transactions constituting "tax-free reorganizations" under the 1954 Code is contained in Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Proposals" at 607-616.

Posin has described the Act as proceeding in a two-step assault on the fundamental principles of current law for tax-free acquisitive reorganizations. First, the basic reorganization concept is repealed by eliminating the continuity of interest, continuity of business enterprise, and business purpose doctrines, by partially uncoupling the corporate and shareholder level tax results, and by determining each shareholder's tax consequences independently of the other shareholders. The present statutory definitions of acquisitive reorganizations are replaced by the two types of qualified acquisitions. Second, the corporate parties to a qualified acquisition can explicitly elect the tax consequences, i.e., gain recognition to the target and related stepped-up basis to the acquiring corporation. <u>See</u> Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web" at 1395.

79/<u>See</u> Regs. 1.368-1(c) and 1.368-1(g). Problems caused by the requirement that tax-free acquisitive reorganizations must proceed under a plan of reorganization are discussed in Faber, "The Use and Misuse of the Plan of Reorganization Concept," 38 <u>Tax L. Rev</u>. 515 (1983).

80/The Act states: "Current law links the shareholder level consequences of a reorganization to the corporate level consequences and to the tax treatment of other shareholders in the transaction. This produces a number of anomalous results." Subchapter C Revision Act at 41.

81/As is the case under current law, the deferred recognition of the shareholder/security holder level nonrecognized gain or loss is accomplished through the related basis rules. The Act provides a general rule that the shareholders and security holders of the target corporation will obtain a substitute basis in any qualifying consideration received and a fair market value basis in any nonqualifying consideration received. The Act uses the term "substitute" basis while the term "substituted" basis is more commonly used under current law. Both terms mean that the stock or securities of the acquiring corporation received by the shareholders of the target corporation will take a federal income tax basis in the hands of the recipient which is derived from the federal income tax basis of the target corporation stock or securities surrendered. As is the case of the present basis rules under Sec. 358, these rules are designed to ensure the eventual recognition of the realized gain or loss which was not immediately recognized as a result of the tax-free reorganization. The Act also provides a general rule that the controlling shareholders of the target corporation will obtain an income tax basis in any qualifying consideration received equal to the lesser of a substitute basis or a fair market value basis. See Subchapter C Revision Act at 53.

82/The final acquisition proposals were issued in May 1985 prior to the enactment of the Tax Reform Act of 1986 in October 1986. The Act states that qualified acquisitions were to include liquidating sales under the 12-month complete liquidation provisions of Sec. 337 due to the desire to define "qualified acquisitions" broadly to include all types of economically equivalent acquisitive transactions under the 1954 Code and to include those statutory provisions which codified the now repealed General Utilities doctrine. The Tax Reform Act of 1986 repealed Secs. 336 and 337 which provided that a liquidating corporation would generally not recognize gain or loss upon an in-kind distribution or sale of its assets as part of a complete liquidation. Secs. 336 and 337 thus codified the now repealed General Utilities doctrine. Sec. 337 of the 1986 Code provides special nonrecognition rules for the upstream liquidations of controlled subsidiaries into their parent corporations in which the subsidiary generally does not recognize gain and the parent generally takes a carryover basis in the subsidiary's assets. Because Sec. 337 of the 1986 Code deals with a much different situation than Sec. 337 of the 1954 Code, the intention of the Subchapter C Revision Act suggests that qualified acquisitions would not include transactions described in Sec. 337 of the 1986 Code.

83/The eight forms of tax-free acquisitive reorganizations defined in the 1986 Code are: (1) the direct merger of target into acquiring corporation under Sec. 368(a)(1)(A); (2) the forward triangular (subsidiary) merger under Sec. 368(a)(2)(D); (3) the reverse triangular merger under Sec. 368(a)(2)(E); (4) the direct stock-for-stock exchange under Sec. 368(a)(1)(B); (5) the subsidiary stock-for-stock exchange under Sec. 368(a)(1)(B); (6) the direct acquisition of target's assets under Sec. 368(a)(1)(C); (7) the subsidiary acquisition of target's assets under Sec. 368 (a)(1)(C); and (8) the "over and down" acquisition in which the assets or stock of the target is contributed or "dropped down" to a controlled subsidiary of the acquiring corporation under Sec. 368(a)(2)(C).

84/Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance and Process" at 42.

85/The Act would thus codify the 70/90 percent advance ruling position as to what constitutes "substantially all" of the target's assets under current law for certain acquisitive tax-free reorganizations. These 70/90 percent requirements and related tax planning issues are discussed in detail in Flinn, "C Reorganizations Under The Internal Revenue Code of 1986: Is More Tax Reform Needed?" 35 Oil & Gas Tax Q. 645 (1987).

86/Control is defined in the same manner as under Sec. 1504(a)(2) of the 1954 Code.

87/Thompson notes that the triangular "B" reorganization under Sec. 368(a)(1)(B), the triangular stock-for-asset reorganization under Sec. 368(a)(1)(C) and the forward and reverse triangular mergers under Secs. 368(a)(2)(D) and (E) are in essence codified in the Subchapter C Revision Act. See Thompson, A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Proposals" at 623.

88/See Subchapter C Revision Act at 38. Many of those who testified before Congress on the acquisition proposals applauded the broad definition of transactions eligible for tax-free treatment at the corporation level envisioned by Proposal One.

The American Institute of Certified Public Accountants (AICPA) reiterated its long-standing support for standardization of the definitional structure for acquisitive transactions and the elimination of arbitrary statutory standards. The AICPA stated that the institution of a more rational and better understood taxing regime for acquisitive transactions will reduce complexity and reduce incentives for structuring transactions in an artificial manner solely to take advantage of discontinuities in the tax law. See 1985 Hearings on Reform of Corporate Taxation at 324-325.

Eustice testified that eliminating the "alphabet soup" of statutory definitions for the various forms of tax-free acquisitive reorganizations and their varying consideration requirements would in and of itself make the acquisition proposals worth enacting. (emphasis added) Eustice stated:

> Adoption of an explicitly elective system governing the corporate-level tax consequences of a 'qualified acquisition' and adoption of a uniform definition for 'qualifying acquisitions' creates a significantly superior regime to the transactional electivity and definitional chaos that exists in the current law.

<u>See</u> 1985 Hearings on Reform of Corporate Taxation at 143-144.

89/<u>See</u> Buchholz, "The Consistency Requirements of Section 338--Inconsistencies and Incongruities." In testifying on the acquisition proposals, Adinoff, a tax lawyer, stated that Congress should not be overly impressed by the apparent simplicity of explicit elections of tax consequences. Adinoff stated that although the enactment of Sec. 338 in 1982 (replacing Sec. 334(b)(2)) was to have been a great simplification of the tax law for taxable acquisitive transactions:,

> the election was literally riddled with exceptions and qualifications all aimed at preventing the acquisition of some assets with a stepped-up basis and others with a carryover basis [the consistency requirements]. The rules to require such consistent treatment nearly doubled the size of the statutory provision, have already produced more than a hundred pages of regulations, and have caused a very large segment of the tax bar to regret that the measure was ever enacted.

1985 Hearings on Reform of Corporate Taxation at 204.

The acquisition proposals allow the acquiring corporation complete selectivity in making a cost or carryover basis election for QAs.

In testifying on the Preliminary Staff Proposals, representatives of Deloitte Haskins and Sells were not enthusiastic about the separation of corporate and shareholder level consequences:

> However, rules separating the tax treatment of shareholders from those of their corporations should be enacted only after careful study. Elections are not necessarily simpler than the provisions they replace. Section 338 of the Code, enacted just last year, was supposed to simplify the provision by enabling corporate taxpayers to treat stock acquisitions as asset acquisitions, but the statute will require at least nine major regulation provisions, none of which has yet been published by Treasury. Despite two technical correction bills, Section 338 is still not workable in day-to-day transactions.

1983 Hearings on Reform of Corporate Taxation at 458.

90/<u>See</u> 1983 Hearings on Reform of Corporate Taxation at 280.

91/See 1983 Hearings on Reform of Corporate Taxation at 86-88. In 1981, the ABA Tax Section adopted a legislative recommendation to streamline and make uniform the statutory definitions of tax-free reorganizations. This recommendation assumes that the tax law will continue to require at least some stock consideration as a prerequisite to tax-free treatment. See "ABA Tax Section Recommendation No. 1981-5," reported at 34 Tax Law. 1386 (1981).

Many of those who testified before Congress on the Preliminary Acquisition Proposals expressed support for eliminating the unnecessarily complex definitional provisions of Sec. 368(a)(1) and eliminating the categorical distinctions between economically similar acquisitive transactions.

92/1983 Hearings on Reform of Corporate Taxation at 213.

93/Posin notes that the draft legislation accompanying the Act is over 130 pages of double-spaced typed material, that the acquisition proposals are quite complex, and that the "mirror basis rules" for subsidiaries under Proposed Section 1020 is extremely complex. Posin concludes that the taxing regime proposed by the Act may be as complex as the present Subchapter C provisions for acquisitive transactions. See Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1395-1396. The acquisition proposals are quite detailed and complex. See Subchapter C Revision Act at 77-208.

94/1983 Hearings on Reform of Corporate Taxation at 457. Deloitte, Haskins and Sells also noted that if an acquiring corporation wants to use its voting stock to acquire control of a target, the transaction could be structured as either a straight "B" reorganization or a reverse subsidiary merger under Sec. 368(a)(2)(E). The "B" reorganization would allow only the use of voting stock as consideration while the reserve subsidiary merger would allow up to twenty percent of the consideration to be other than voting stock. The firm asserted that there can be no compelling tax policy rationale for such a difference in economically similar transactions.

95/See, e.g., Thompson, "A Suggested Alternative Approach to The Senate Finance Committee Staff's Proposals For Revising The Merger And Acquisition Proposals" at 625.

96/See, e.g., Robinson, "Tax Interpretation: Lessons From The Reincorporation Cases," XXXIV U. Fla. L. Rev. 1 (1981) at 1. Robinson states:

> Because of the special importance of statutory language in a self-assessing tax system, flexible methods of interpretation [the judiciary interprets the statute as needed in order to prevent tax abuse] should be tightly controlled. When the codified language leads to a wrong result, the language should be amended, rather than altered by judicial interpretation.

97/1982 ALI Study at 28.

98/Id., at 26.

99/Id., at 28.

100/Id., at xii.

101/Subchapter C Revision Act at 38. Ginsburg is very critical of the definitional provisions of the current law:

> Determining whether a given transaction qualifies as a [tax-free] reorganization may require mastery of statutory, administrative, and judge-made rules so arcane, complex, and disparate as to boggle the mind. Present law [the 1954 Code] comprehends an extraordinary number of acquisitive reorganization ways in which P [parent corporation] or S [controlled subsidiary] may obtain the common stock or assets of a solvent T [target corporation.]
>
> Delivery of P stock is the factor common to all of them. From there confusion reigns. In some transactions, the P stock must be voting stock. In others, any sort of P stock will do. In some transactions, solely P stock must be issued. In some, a limited amount of other consideration is acceptable. In some, a generous amount of other consideration can be used. In certain transactions, substantially all of the properties of T must end up in the right hands. In others no such treatment obtains.
>
> Obviously, the reorganization provisions do not operate in a neutral fashion. In aid of no conceivable tax policy, the most sensible commercial transaction may be condemned; for the parties, to achieve an acceptable tax result, are forced to proceed in a commercially inferior manner.

Ginsburg, "Taxing Corporate Acquisitions" at 201.

102/Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Proposals" at 625.

103/Id., at 626. Thompson notes that one of the most pressing tax planning problems created by the various and differing "substantially all" tests is in the Section 355 area. The cases and rulings indicate that although it is nearly impossible to spin off either the desired or undesired assets of the target under Sec. 355 prior to a "C" reorganization or a forward or reverse subsidiary merger due to the likelihood of failing the substantially all of the assets tests, it is possible to combine a pre-acquisition spin off by the target with a later "A" reorganization (merger) of either the distributing target into the acquiring corporation or the spun-off controlled corporation into the acquiring corporation. The target may also spin off unwanted assets in a Sec. 355 transaction prior to the acquisition of the distributing target (now holding its remaining assets) by the acquiring corporation in a "B" reorganization. Id., at 626. For a discussion of the role of Sec. 355 in the post-General Utilities world, see Simon and Simmons, "The Future of Section 355," 40 Tax Notes 291 (July 18, 1988).

104/See the Appendix.

105/See generally Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?"

106/See Id., at 292.

107/The current tax law links the corporate level and shareholder actions to whether the overall transaction constitutes a "tax-free reorganization." Stated differently, both the corporate and shareholder level tax consequences are based on whether the parties to the reorganization act in the manner envisioned by the early statutory provisions and judicial decisions.

If a transaction does not constitute a "tax-free reorganization" at the corporate level, the nonrecognition and substituted basis provisions of Secs. 354, 355, 356, and 358 cannot be used by the shareholders and security holders of the target corporation. The linkage allows both acquiring corporation actions which cannot be prevented by the shareholders and security holders of the target and target shareholder and security holder actions which cannot be prevented by the corporation to prevent or upset desired tax-free reorganization treatment. The elimination of the continuity of interest and continuity of business enterprise requirements would do much to sever this linkage.

108/The acquisition proposals have been criticized for expanding the operative provisions now applicable to tax-free acquisitive reorganizations to a much broader class of acquisition transactions. The principal reasons include: (1) Elimination of each of the three common law doctrines as a prerequisite for qualified acquisition treatment. (2) Allowing explicit electivity of the corporate level tax consequences of qualified acquisitions regardless of the type of consideration used by the acquiring corporation. If a carryover basis election is made, the target corporation will not recognize gain even if the acquiring corporation uses only cash consideration. Several commentators feel these tax consequences deviate too far from traditional notions of realization and recognition. See, e.g., Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Proposals."

109/Faber notes that although the income tax regulations have contained statements that reorganizations effect only a readjustment of continuing interests in property under modified forms (see, e.g., Regs. 1.368-1(b)) for over 45 years, the terms "continuity of interest" and "continuity of business enterprise" are still relatively undefined. Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 239.

The regulations have contained a continuity of interest requirement as a prerequisite for tax-free reorganization treatment since 1934. See Ferrero, "Continuity of Interest Revisited" at 44-10 and Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 130.

The regulations have contained a continuity of business enterprise requirement as a prerequisite for tax-free reorganization treatment since 1935. See Treas. Reg. 86 Sec. 112(g)-1 (1935); Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 315; and Libin, "Continuity of Business Enterprise: The New Regulations" at 4-3.

110/Faber and other commentators agree that the Service and the courts have often used the lack of continuity of business enterprise as a secondary weapon to find lack of tax-free reorganization status when it was not clear that the transactions lacked a business purpose sufficient to deny tax-free reorganization status. See Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 292. Faber argues that because the Service and the courts have so consistently used the continuity of business enterprise requirement as a subset of the business purpose doctrine, the outright repeal of the continuity of business enterprise requirement would simplify the current law without reducing the ability of the Service and the courts to combat abusive schemes.

Faber notes a number of inconsistencies in the continuity of business enterprise requirement:

> There should be no continuity of business enterprise requirement other than the requirement that there be a business purpose for the transaction. A transfer of corporate assets of any nature, business or non-business, by T [target corporation] in exchange for A's [acquiring corporation] stock should be tax-free at the shareholder level if the statutory tests are met. The sale of T's assets by T before the reorganization or by A afterward and the use of the sale proceeds in A's business should not prevent tax-free reorganization treatment.
>
> Allowing a change in the nature of a corporation's assets or operations at the corporate level to trigger recognition of gain for the shareholder would be inconsistent with the treatment of shareholders and corporations as separate entities. If a corporation sells all of its assets and invests the proceeds in a new business, or for that matter, marketable securities, the shareholders are not taxed, even though they now hold interests in an investment company, not an operating company, and their position has been substantially changed. If the fiction of the reorganization provisions that A is a mere continuation of T is to be observed, there is no reason to treat a change in A's business or assets as being different from a change in T's as if there had been no reorganization.

Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 292.

111/See 1983 Hearings on Reform of Corporate Taxation at 188-189. The TEI generally endorsed efforts to simplify and streamline the definitions relating to tax-free acquisitive transactions.

112/1983 Hearings on Reform of Corporate Taxation at 25.

A discussion of why the continuity of interest doctrine should be repealed is contained in Wolfman, "'Continuity of Interest' and the American Law Institute Study," 57 TAXES 840 (1979).

113/1983 Hearings on Reform of Corporate Taxation at 25. The Treasury Department stated:

> However, we are concerned about the complete abolition of the continuity of business enterprise [doctrine] in tax-free acquisitions. For example, if Target sells all of its assets for cash and then merges into Acquiring, it may be appropriate to tax Target shareholders on the receipt of Acquiring stock, as the Target shareholders arguably have no continuing interest in Target enterprise upon which nonrecognition of realized gain can be justified. By the same token, however, we recognize that it may be difficult to distinguish cases where a continuing investment in fact exists from those in which it does not.

Id.

114/See H. R. Rept. No. 704, 73rd Cong., 2nd Sess. (1934) at 13.

115/McGaffey and Hunt, "Continuity of Shareholder Interest in Acquisitive Reorganizations" at 682. McGaffey and Hunt note that if under the 1954 Code, "the objective of the federal income tax system were to maximize revenue for the Treasury, it may well be that the greatest advantage would be to have either no continuity-of-interest requirement or a very low level of continuity required." Id., at 680. McGaffey and Hunt note that under the 1954 Code, the federal income tax would be maximized if tax-free reorganization status was more easily achieved. The acquiring corporation must take a carryover basis, instead of a fair market basis, for the assets received from the target. If the shareholders of the target corporation receive cash, they will have to recognize gain. If the transaction is a tax-free reorganization, some of the gain may be characterized as dividend income under Sec. 356. If the transaction is a simple sale of stock or the receipt of a liquidating distribution, the gain would most likely be characterized as capital gain, long- or short-term depending on the holding period of the stock in the hands of the shareholders.

116/The qualitative aspect of the continuity of interest requirement, as expressed in Regs. 1.368-2(a), deals with whether the nature of consideration received by the shareholders of the target corporation indicates they have a continuing proprietary interest in the assets of the target corporation.

Bittker and Eustice note the qualitative continuity of interest requirement operates in a mechanical manner that often emphasizes form over economic substance:

> Although the continuity-of-interest doctrine was devised and applied as a means of denying tax-free treatment to 'sales' that happen to meet the literal requirements of a reorganization, it works more as a blunt instrument than as a sharp scalpel.

Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders at 14-29.

Bittker and Eustice also question the assumption that the receipt of acquiring corporation stock insures continuity of interest while the receipt of bonds issued by the acquiring corporation can never satisfy the continuity of interest requirement:

> In fact, the exchange may drastically alter the shareholder's rights and risks. If he gives up common stock of a closely held corporation and gets back marketable stock of a national, publicly held corporation, the exchange may be substantially the same as a sale of the original stock followed by an investment of the proceeds in a totally different enterprise.
>
> In applying the continuity-of-interest doctrine, the courts have employed the converse, but almost equally mechanical, assumption that bonds cannot represent a 'proprietary' interest in the reorganized corporation yet the size or financial status of the obligor may give the 'creditor' good reason to worry about the safety of his investment, and to follow the fate of the transferred assets with acute concern.
>
> Finally, the exchange of a 'proprietary' interest for bonds may not represent much of an economic shift, if the stock given up was nonparticipating preferred, or common stock of a corporation whose assets were not likely to fluctuate in value or yield. An example is Roebling v. Comm., where the continuity-of-interest doctrine was applied to deny tax-free status to an exchange of common stock for bonds, although the exchange did not produce a substantial difference in

the investor's financial position.

Id., at 14-29 and 14-30.

The tax literature notes that the Service and the courts have used the continuity of interest requirement in ways other than that stated in the early judicial decisions, have not applied the requirement consistently across taxpayers, and, as noted, have applied the requirement in a rather mechanical fashion which emphasizes form over economic substance. Bloom and Sweet, for example, state:

> However, the continuity-of-interest doctrine applied by the Service today serves a significantly different purpose than that contemplated by the Supreme Court, and it is remarkably free of specific judicial support in its present role.

Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 130.

Several commentators feel the current interpretation of the continuity of interest requirement in Regs. 1.368-2(a) is rather inflexible and does not recognize the reality that in many cases the tax-free reorganization provisions apply to affiliated groups of corporations rather than a single corporation owned only by individual shareholders. The problem is particularly acute for the various types of triangular reorganizations allowed by the 1986 Code. Discussions of direct and indirect (or remote) continuity of interest are contained in Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 137-138; Ferrero, "Continuity of Interest Revisited" at 44-15 through 44-17; and Kovey, "Characterizing Reorganizations by Reference to the Historic Shareholder" at 129-132.

Several commentators point to the Supreme Court's recent decision, Paulsen v. Comm., 105 S. Ct. 627 (1985), as an example of a elevation of form over economic substance. Paulsen followed Rev. Rul. 69-6, 1969-2 CB 104, and held that a statutory merger of a stock savings and loan association into a mutual savings and loan association in which the surrendering shareholders received passbook interests in the acquiring mutual association did not satisfy the continuity of interest requirement and thus did not constitute a tax-free association as defined in Sec. 368(a)(1)(A). The Supreme Court's decision is discussed in Henkel, "Paulsen v. Commissioner: Supreme Court Follows Minnesota Tea to a Tee," 67 TAXES 647 (1985). Some tax policy implications for the financially troubled thrift institutions in the United States are discussed in Soukup, "The Continuity-of-Proprietary Interest Doctrine and Thrift Institution Mergers."

Bloom and Sweet object to the Service's positions in Rev. Rul. 69-3, 1969-1 CB 103 (holding that a merger of one mutual savings and loan association into another satisfied the continuity of interest requirement) and Rev. Rul. 69-6 (holding that the merger of a stock savings and loan association into a mutual association did not satisfy the continuity of interest requirement). Bloom and Sweet state:

> The only basis for distinguishing these two Rulings was that in Rev. Rul. 69-3, those people who owned the proprietary interest in the acquired corporation received interests substantially identical to those given up whereas in Rev. Rul. 69-6, the interest received was significantly more liquid and more equivalent to cash than that given up.
>
> While this distinction does not seem objectionable from an equity viewpoint since the substance of the transaction Rev. Rul. 69-6 was, in fact, an exchange of a stock interest for a cash equivalent, it does introduce an analysis which is beyond the scope of the continuity of interest doctrine. Continuity of interest focuses solely upon the type of interest in the acquiring corporation received by the owners of the acquired corporation and does not look to the type of security given up in exchange therefore. If the continuity of interest doctrine were to be extended to analyze net liquidity changes, more conventional reorganizations such as the exchange of a common stock interest in a closely-held corporation for a nonvoting preferred stock interest in a publicly held corporation would also be suspect.

Bloom and Sweet, "How IRS uses continuity of interest to raise problems in reorganizations" at 131.

117/The quantitative aspect of the continuity of interest requirement, as expressed in Regs. 1.368-2(a), deals with whether the amount of the consideration received by the shareholders of the target corporation "represent a substantial part of the value of the stock or property transferred" to the acquiring corporation as required by the Supreme Court in Minnesota Tea v. Helvering, 302 U.S. 609 (1938).

For advanced ruling purposes, the Service has used a fifty percent interpretation since 1966. Rev. Proc. 77-37, 1977-2 CB 568, provides that for advanced ruling purposes, the continuity of interest requirement is satisfied if, in the aggregate, the shareholders of the target corporation receive stock of the acquiring corporation which is at least equal to fifty percent of the value of all the formerly outstanding stock of the target corporation. The predecessors of Rev. Proc. 77-37 also provided a fifty percent interpretation. See Rev. Rul. 66-24, 1966-2 CB 114, and Rev. Rul. 74-26, 1974-2 CB 478.

Despite the Service's advance ruling position, the tax literature notes practitioners have no clear-cut guidance on the quantitative aspects of the continuity of interest requirement. See, e.g., Ferrero, "Continuity of Interest Revisited" at 44-10.

Bloom and Sweet state:

> The question of whether or not there is a sufficient continuity of interest for a reorganization has rarely come before the courts. It is not clear whether this is a result of the Service's reluctance to pursue the matter, or whether taxpayers have simply been fairly conservative in making sure that the Service's rather restrictive requirements are met.

Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 132.

Because the statutory definitions state the type of consideration which can be used for most acquisitive reorganizations, the problems caused by the lack of clear-cut guidance is most acute for statutory mergers and consolidations defined in Sec. 368(a)(1)(A) in which the statute is silent as to the type of consideration which may be used. Bittker and Eustice note the importance of satisfying the continuity of interest test in reorganizations defined in Sec. 368(a)(1)(A):

> Aside from the continuity-of-interest problem, relating to the proportion of nonproprietary consideration which can be paid by the acquiring corporation, statutory mergers and consolidations ordinarily cause little difficulty.

Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders at 14-33.

Many state merger laws allow cash-option mergers. The acquiring corporation's use of all cash consideration would clearly fail the continuity of interest requirement because the former shareholders of the target corporation would have no continuing ownership interest in the acquiring corporation. Cash-option mergers generally are structured to satisfy the Service's fifty percent interpretation described above. Cash-option mergers are described and discussed in Ferrero, "Continuity of Interest Revisited" at 4-11. Tax problems for cash-option mergers are discussed in McGaffey and Hunt, "Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations."

Ferrero has described cash-option mergers and the Service's fifty percent ruling position as follows:

> In a typical cash-option merger the shareholders of the acquired corporation are given the option of taking either cash or stock in the acquiring corporation in exchange for their stock in the acquired corporation. However, in order to insure that those shareholders opting for stock can do so tax-free, the terms of the offering will provide that in no event will less than 50 percent of the consideration issued take the form of stock. In the event that the cash portion of the offering is oversubscribed, those electing cash will be required to take a combination of stock and cash.

Ferrero, "Continuity of Interest Revisited" at 44-11. The requirement that some shareholders will be forced to take some stock is called a "cram down" provision.

Ferrero joins other commentators in noting that it may be difficult to satisfy the literal requirements of Rev. Proc. 77-37 in structuring and executing cash-option mergers. See McGaffey and Hunt, "Continuity of Shareholder Interest in Acquisitive Reorganizations" at 665-670 and Ferrero, "Continuity of Interest Revisited" at 44-11. Ferrero states that he is not aware of any instance in which the Service has raised the issue of lack of continuity of interest in cash-option mergers but cautions practitioners to avoid technical violations of Rev. Proc. 77-37 if possible.

118/The temporal aspect of the continuity of interest requirement, as expressed in Regs. 1.368-2(a), deals with the issue of whether the length of time the former share holders of the target corporation actually hold the stock of the acquiring corporation indicates they have a continuing proprietary interest in the assets of the target.

As demonstrated in McDonald's of Zion, 432, Ill. Inc., 76

TC 972 (1981), rev'd McDonald's Restaurants of Illinois v. Comm., 668 F.2d 520 (7th Cir. 1982) and in the uncertainty surrounding risk arbitrage activities in the United States, the temporal aspects (i.e., pre- and post-reorganization continuity of interest) of the continuity of interest doctrine are not well settled and continue to cause uncertainty for taxpayers and their advisers. See generally McGaffey and Hunt, "Continuity of Shareholder Interest in Acquisitive Reorganizations" at 670-680; Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 254-261; and Calvert and Erickson, "How to meet the continuity of interest requirement for tax-free reorganizations" at 360-362. The McDonald's litigation is discussed in Brown, Berkowitz and Lynch, "McDonald's of Zion: application of the step transaction doctrine to the continuity of interest test" and Prusiecki, "Continuity of interest in tax-free mergers: new opportunities after McDonald's of Zion," 55 J. Tax'n 378 (1981).

Commentators note that the Service's litigating position in McDonald's is totally inconsistent with the positions taken in Rev. Proc. 66-23 and Rev. Proc. 77-37. In order to force the acquiring corporation to take a carryover basis, instead of a fair market value basis, in the franchised restaurants acquired from the target, the Service argued that the clear violation of the continuity of interest doctrine by the shareholders of the target should be ignored. Prusiecki states:

> The McDonald's opinion undermines the relative certainty the tax community previously had enjoyed rerarding the effect on continuity [of interest] a relatively prompt post-merger sale [of the acquiring corporation stock received in the purported tax-free reorganization] pursuant to a premerger intent to sell. While lack of certainty can present opportunities for aggressive tax planning, it also restricts the relative flexibility of those with a more timid bent and of those who cannot afford to do battle with the Service.

Prusiecki, "Continuity of interest in tax-free mergers: new opportunities after McDonald's of Zion" at 380.

Bloom and Sweet describe the temporal issue in the following manner:

> If the shareholders of an acquired corporation receive the requisite continuity of interest in a reorganization, the question quickly arises as to

> whether they must retain the stock interest in the acquiring corporation they receive or whether they may dispose of such interest at will. If the shareholders of the acquired corporation immediately, and as part if the plan [of reorganization], sell the stock they receive, it would appear reasonable to say that such shareholders never intended to participate in a tax-free reorganization but simply intended to sell their stock for cash. Therefore, the transaction should not be treated as a reorganization and the continuity of interest doctrine should be relied upon to deny tax-free treatment o the transaction.

Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 133.

Rev. Proc. 77-37, 1977-2 CB 568, contains the Service's interpretation of the continuity of interest doctrine for advance ruling purposes. Sec. 3.02 of Rev. Rul. 77-37 states sales, redemptions, and other dispositions of stock occurring prior to or subsequent to the exchanges which are part of the plan of reorganization will be considered in determining whether the former shareholders of the target corporation have the required 50 percent continuing ownership interest as of the effective date of the reorganization.

Commentators note that for purposes of Rev. Rul. 77-37, the "plan of reorganization" is to be construed in the broadest possible sense to include any transactions contemplated in connection with the reorganization. This construction of the term far outstrips the normal step transaction doctrine and frees the Service from having to find sham transactions, transistory transactions, or mutual interdependence of transactions in order to deny tax-free reorganization treatment due to lack of continuity of interest. <u>See</u> Bloom and Sweet, "How IRS uses continuity of interest to raise new problems in reorganizations" at 134 and Blanchard, "Creeping Asset Acquisitions After TEFRA: On Reconciling the Irreconcilable."

In spite of this broad construction of the term "plan of reorganization" for advanced ruling purposes, a review of the administrative pronouncements and judicial decisions indicates there is apparently no minimum period of time for which continuity of interest, once established, must be maintained in order not to violate the continuity of interest requirement.

In Rev. Rul. 56-345, 1956-2 CB 206, the Service held that if the recipient of acquiring corporation stock had no intention of disposing of the stock at the time of the reorganization exchanges but did actually dispose of the stock one month after its receipt, the disposition of the stock would not cause the continuity of interest requirement to be violated.

In Rev. Rul. 66-23, 1966-1 CB 67, the Service held that if a recipient of stock of the acquiring corporation had no "preconceived plan" to dispose of the stock, and had the right to retain the stock for at least five years, the stock will be included in determining whether the continuity of interest requirement was satisfied. Rev. Rul. 66-23 is inconsistent with Stephens, Inc., 464 F.2d 53 (8th Cir. 1972), cert. den. 409 U.S. 1118 (1973) which held that continuity of interest existed even if the former shareholders of the target corporation intended to sell the acquiring corporation stock immediately upon receipt.

Arbitrage activity in the stock of actual and potential target corporations raises a number of pre-and post-reorganization continuity of interest problems, particularly in view of the broad interpretation of the term "plan of reorganization" in Rev. Proc. 77-37. Investment banking firms and other institutions and individuals attempt to make a profit by analyzing corporate takeover bids and then taking positions that will be profitable if the acquisition is actually consummated. See generally Report on Hostile Takeovers at 19.

Posin notes arbitrageurs rarely acquire more than thirty percent of the stock of an actual or potential target corporation. Because Rev. Proc. 77-37 only requires a fifty percent continuity of interest, the relationships between arbitrageurs and the continuity of interest requirement has not yet been litigated. See Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1364-1369.

119/Many commentators feel the interpretation of the continuity of business enterprise requirement in Regs. 1.368-1(d) represents poor tax policy, is inconsistent with both the case law and long-standing administrative interpretations of the requirement, and forces all taxpayers into a "solution" (the requirement that the acquiring corporation either continue a business conducted by the target corporation or use the historic assets of the target in its business) to a specific problem (the mutual fund issue described below) which Congress has resolved by making changes in the statute itself (see Sec. 368(a)(2)(F)). See Bloom, "The Resurrection of a Dormant

Doctrine: Continuity of Business Enterprise"; Libin, "Continuity of Business Enterprise: The New Regulations," and Halpert, "Continuity of Business Enterprise Regulations Invigorates a Dormant Doctrine."

The mutual fund transactions that prompted Congress to enact Sec. 368(a)(2)(F) are described and discussed in detail in Aidinoff and Lopata, "The Continuity of Business Enterprise Requirement and Investment Company Reorganization." The basic transaction involved attempts by shareholders of closely-held corporations to sell out for cash and simultaneously secure the benefits of tax-free reorganization treatment by engaging in a purported "reorganization" with a mutual fund.

Other commentators feel that because the courts and the Service have so consistently used the continuity of business enterprise doctrine as a subset of the business purpose doctrine, the continuity of business enterprise doctrine is redundant and unnecessary, and only serves to make the tax law less certain. See, e.g., Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 292 and Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 316.

Libin notes that the continuity of business enterprise requirements as stated in Regs. 1.368-1(d) are virtually unsupported by the prior case law and administrative rulings. Libin, "Continuity of Business Enterprise: The New Regulations" at 4-10, 4-11 4-19, 4-21 through 4-22. Other commentators agree. See also Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 331 and Halpert, "Continuity of Business Enterprise Doctrine Regulations Invigorates a Dormant Doctrine" at 50-27, 50-38.

Bloom notes that the continuity of business enterprise regulations place a very high premium on which of the corporations involved in an acquisitive transaction is the acquired corporation, i.e., the corporation whose historic business does not have to be continued, and which corporation is the target corporation, i.e., the corporation whose historic business must be continued. Libin notes this emphasis on form over substance is poor tax policy and that, in many situations, the intent of the regulations can be avoided simply by reversing the contemplated steps and having the corporation that is discontinuing its business acquire the corporation operating the business that will be continued. See Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 4-22 and Halpert, "Continuity of Business Enterprise Doctrine Regulations Invigorates a Dormant Doctrine" at 50-20 and 50-21.

120/Spear notes the early statutory provisions and regulations do not contain any substantive discussion of whether Congress intended that a "business purpose" requirement serve as a prerequisite for tax-free reorganization treatment. See Spear, "'Corporate Business Purpose' in Reorganizations" at 230. The tax literature strongly suggests that because no case as extreme as Gregory v. Helvering, 293 U.S. 465 (1935), had yet come before the courts, Congress did not express any particular concern about business purpose and that any purpose aside from outright tax avoidance would be acceptable. The Senate Finance Committee Report on the Revenue Act of 1924 noted the difficulties which can arise when tax consequences depend on the taxpayer's motives or intentions:

> The intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis for determining tax liability.

S. Rept. No. 398, 68th Cong., 1st Sess. (1924) at 14.

The Committee Reports on the Revenue Act of 1934 give no indication of Congressional approval or disapproval that a business purpose requirement should serve as an explicit prerequisite for tax-free reorganization treatment. See Spear, "'Corporate Business Purpose' in Reorganizations" at 232.

The Supreme Court's decision in Gregory v. Helvering created the requirement that a transaction or series of transactions must have a "business or corporate purpose" in order to be recognized for tax purposes. Spear notes that although Gregory v. Helvering has been cited in hundreds of subsequent decisions, the precise meaning of "business or corporate purpose" is still indefinite and uncertain. See Spear, "'Corporate Business Purpose' in Reorganizations" at 235.

There are several difficulties in determining the boundaries of the business purpose doctrine and how it interacts with the other judicial doctrines, particularly the continuity of business enterprise doctrine and the step transaction doctrine. One is that the Supreme Court has heard very few post-Gregory cases in which the classification of the transaction as a tax-free reorganization rested primarily on whether the business purpose requirement was satisfied. Another problem is that many commentators and courts read the two Minnesota Tea decisions (Helvering v. Minnesota Tea Company, 296 U.S. 378 (1935) and Minnesota Tea Co. v. Helvering, 302 U.S. 606 (1938)) as standing for the proposition that the form of the transaction used by the taxpayer will be accepted unless the transaction is clearly a sham transaction motivated solely by tax purposes. For example, in Higgins v. Smith. 308 U.S. 473 (1940) at 476, the Supreme Court limited Gregory v. Helvering to the proposition that "a transfer of assets without business purpose but solely to reduce tax liability" could be disregarded for income tax purposes. In Moline Properties, Inc. v. Comm., 319 U.S. 436 (1943) at 439, the Supreme Court cited Gregory v. Helvering as standing for the proposition that the corporate form may be disregarded for tax purposes where it is a sham or unreal.

Until the Supreme Court introduced the "corporate business purpose" (as distinguished from the "business purpose" in Gregory v. Helvering) in Bazley v. Comm., 331 U.S. 737 (1947), the federal courts and the Board of Tax Appeals generally followed what Spear has described as the Supreme Court's "restrictive interpretation" of Gregory v. Helvering. The courts generally confined Gregory v. Helvering to sham transaction cases and other cases in which the tax avoidance motive was predominant. See Spear, "'Corporate Business Purpose' in Reorganizations" at 237.

See, e.g., Electrical Securities Corporation, 34 BTA 988 (1936) (in which a series of transactions the sole purpose of which was to avoid corporate level taxes was held not to be a reorganization) and J.D. and A.B. Spreckels Co., 41 BTA 370 (1940) (in which the merger of a profitable and a loss corporation motivated solely by the desire to reduce corporate level taxes was held not to be a reorganization in part because saving taxes is not a valid business purpose).

Many of the problems encountered in attempting to determine the boundaries of the business purpose doctrine have arisen when courts have tried to distinguish the corporate and shareholder business purposes for transactions. Spear states:

> It is submitted that it is a disregard of the realities of the proprietary objectives of the shareholders, particularly in such instances as the Adams and Bazley cases, to distinguish between the two purposes. It is certainly not inconsistent with the recognition of the corporate entity to say that its

> shareholders-as-a-group are one and the same. Such a view merely extends the concept that a corporation and its sole shareholder, are, in effect, one and the same.

Spear, "'Corporate Business Purpose' in Reorganizations" at 243.

In commenting on the lack of predictability in business purpose and sham transaction cases, Fuller states:

> The earliest solution remains the most common: a subjective judicial inquiry into the tax avoidance motives underlying the juristic act. In spite of all that has been written about the business purpose doctrine, sham transactions, net effect, and the role of the court looking through form to find substance, no authoritative, explicit rationale for judicial intervention to frustrate plans for tax avoidance has ever been given. The unpleasant conclusion remains that predicting the outcome of a concrete case in many of these areas, after a flood of decisions, remains often difficult and sometimes impossible.

Fuller, "Business Purpose, Sham Transactions And The Relaxation Of Private Law To The Law Of Taxation" at 391.

See also Rice, "Judicial Techniques In Combating Tax Avoidance" (concluding that the business purpose requirement leaves much to be desired in terms of the ability of a taxpayer and his advisers to predict the outcome of a given case based on prior decisions and the court's practice of making decisions by "invective and unmeaningful words" does little to enhance tax planning or predictability of results) and Rigsby, "The Business Purpose Doctrine in Corporate Divisions," 11 Akron L. Rev. 275 (1977) (concluding that any doctrine which determines the tax consequences based on an assessment of the taxpayer's motives will produce unpredictable results).

Summers has studied the major business purpose decisions and concludes that the business purpose requirement should be eliminated as a prerequisite for tax-free reorganization treatment for the following reasons:

1. Findings of fact with respect to taxpayer motivation are not sufficiently reliable because the evidence on which the findings are based can be easily manufactured.

Summers, "A Critique Of The Business Purpose Doctrine" at 41.

2. The judiciary has expressed concern about the ability of the business purpose requirement to meaningfully distinguish business and tax avoidance purposes. In Grantite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1957) at 677, the court refused to apply the business purpose doctrine and emphasized that inquiry into motives only "produces duplicity." In Lewis v. Comm., 176 F. 2d 646 (1st Cir. 1948) at 650, the court stated that reliance on the business purpose doctrine may function as a substitute for analysis.

3. The business purpose doctrine is not necessary to prevent tax abuse. No substitute doctrine is necessary.

Summers, "A Critique Of The Business Purpose Doctrine" at 38, 43, 47.

121/As might be anticipated, critics of the acquisition proposals argue the long-standing judicial doctrines are necessary to distinguish sales which should be immediately taxable and other transactions in which the basis rules can operate to allow the deferred recognition of realized gain or loss. See, e.g, Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions" at 615-618.

Thompson argues that while eliminating the three judicial doctrines may make the law simpler, the Act's relatively heavy reliance on form alone to distinguish sales and QAs "would lead to serious abuses" and "would substantially erode the tax base by greatly expanding the type of exchange that would receive tax-free treatment." Id., at 617-618.

Proponents of the acquisition proposals feel the judicial doctrines are either unnecessary or their uncertain boundaries and interaction with the statutory provisions cause an unacceptably low level of certainty in planning acquisitive transactions. See, e.g., Subchapter C Revision Act at 39-40.

122/1983 Hearings on Reform of Corporate Taxation at 459.

123/The Act would thus abolish the various "remote" continuity of interest problems as in Groman v. Comm., 302 U.S. 82 (1937) and Helvering v. Bashford, 302 U.S. 454

(1938).

124/See, e.g., Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?"

125/As discussed in the text supra, the majority of commentators believe the tax-law for acquisitive transactions is effectively elective. The Act take the position that horizontal equity and avoidance of economic inefficiency requires that the benefits of tax-free treatment for acquisitive transactions should be more readily available to all taxpayers by explicit election rather than only to the well-advised and well-financed through manipulation of the form of the transaction.

126/In commenting on the various overlap problems in Subchapter C, Sachs states:

> In a perfect world, one might expect the statutory draftsman to have produced a harmonious group of provisions which mandate the same tax consequences to a corporate transaction regardless of its [legal] form.

Sachs, "Subchapter C Overlap Problems" 40 Inst. on Fed. Tax'n (1982) at 48-1.

In spite of Gregory v. Helvering and other famous judicial decisions that state the tax consequences of a transaction will be based on its substance and not on its form, Sachs and other commentators demonstrate that many Subchapter C transactions are substantively identical and can often only be distinguished by their form or by the steps takern in achieving the final result. Thus in many acquisitive transactions, the form may be determinative of the substance and the tax consequences because there is no other reliable benchmark. See Id., at 48-2 and 48-3.

The historical development of the tax-free reorganization provisions and other provisions governing taxable and carryover basis transactions have caused economically similar acquisitive transactions to be treated differently based largely on the legal form of the transaction. This situation causes substantial uncertainty, additional costs and delays such as the acquiring corporation having to seek a private letter ruling from the Service to verify its understanding of the tax category and specific consequences of the transaction, and anomalous results for both the corporate and individual parties involved. See Subchapter C Revision Act at 41.

127/The Act states:

> Current law links the shareholder level consequences of a reorganization to the corporate level consequences and to the tax treatment of other shareholders in the transaction. This produces a number of anomalous results.

Subchapter C Revision Act at 41.

128/The Subchapter C Revision Act (at 42) states:

> . . . the failure [of the 1954 Code] to provide a symmetrical system at the corporate level for determining the availability of carryover basis or cost basis to the acquiring corporation causes in large part the linkage of shareholder level and corporate level tax consequences. Repeal of _General Utilities_ would eliminate the need for restrictions of that sort.

129/Lobenhofer, "The Repeal of _General Utilities_ For Corporate Liquidations--The Consequences of Incomplete And Unexpected Tax Reform" at 184.

130/_Id._, at 179.

131/In testifying on the Preliminary Staff Proposals, several practitioners asserted that allowing explicit corporate level electivity and allowing the acquiring corporation to treat assets or stock acquisitions as either cost basis or carryover basis acquisitions should provide for maximum business flexibility and reduce the role of legal form in determining the tax consequences of acquisitive transactions. _See_ 1983 Hearings on Reform of Corporate Taxation at 280.

132/_Id._, at 86-87. Delaney describes the Preliminary Staff Proposals as going to the very fabric of the rules governing the taxation of corporations and their shareholders. _Id._, at 98.

133/The 1982 ALI Study, the Preliminary Staff Proposals and the Act viewed the repeal of the _General Utilities_ doctrine as a necessary condition for this proposal. As also noted, the Treasury Department and the majority of commentators specifically conditioned their support for this proposal on the repeal of _General Utilities_. _See_ 1983 Hearings on Reform of Corporate Taxation at 9.

The heart of Proposal Three is to replace the present system of transactional electivity with a tax regime in which the issues of whether the target corporation recognizes or does not recognition the gain inherent in its assets and whether the acquiring corporation takes a cost or carryover basis for the target's assets, and thus how the potential and conditional tax liabilities of the target at the time of a QA are disposed of, are directly linked. The direct linkage or symmetry of acquiring corporation basis and gain recognition by the target corporation could not be accomplished under the 1954 Code unless the corporate level nonrecognition provisions based on the General Utilities doctrine were repealed. See Subchapter C Revision Act at 42-44. The Treasury Department and other commentators expressly conditioned their support for Proposal Three on the repeal of the General Utilities doctrine.

The vast majority of commentators agree that the corporate level nonrecognition provisions for both nonliquidating distributions (e.g., Sec. 311(b) of the 1954 Code) and liquidating distributions and sales (e.g., Secs. 336, 337, and 338 of the 1954 Code) which were based on the General Utilities doctrine caused a lack of symmetry between the basis of the target's assets to the acquiring corporation and the recognition of gain to the target corporation. Faber states:

> . . . General Utilities results in the transferee [corporation] receiving corporate assets at a market value basis without a full recognition of gain by the transferor [corporation]. This represents a significant exception to one of the general principles of the Internal Revenue Code: The transferee of appreciated property receives a new basis in the property reflecting its cost or its value at the time of the transfer only if the transferor recognizes gain.

Faber, "The Search for Consistency in Corporate Acquisitions" at 192.

134/Faber, "The Search for Consistency in Corporate Acquisitions" at 223-224.

135/1983 Hearings on Reform of Corporate Taxation at 72-73. Andrews also testified that both the 1982 ALI Study and the Preliminary Staff Proposals were predicated on the repeal of the corporate level nonrecognition provisions of the 1954 Code which were based on the General Utilities doctrine. The complete liquidation and the Sec. 338 provisions of the 1954 Code allowed an acquiring corporation to obtain a stepped-up basis in the assets of the target corporation without the recognition of all gain realized by the target. Both the 1982 ALI Study and the Preliminary Staff Proposals viewed the repeal of the General Utilities doctrine as essential (1) to preclude this lack of symmetry and other problems between taxable acquisitions (in which the acquiring corporation takes a stepped-up basis in the assets of the target without a full recognition of gain by the target) and carryover basis acquisitions (in which the acquiring corporation takes a carryover basis in the target's assets and the target generally does not recognize gain) and (2) to eliminate the categorical distinctions and the disparate tax treatment between economically similar "reorganization" and "nonreorganization" acquisitions. Andrews stated the repeal of the General Utilities doctrine and the elimination of the categorical distinctions between various types of acquisitive transactions would themselves enormously simplify the tax law. See Id., at 65-66.

Andrews also stated the repeal of the senselessly complicated statutory definitions of the various types of tax-free acquisitive reorganizations in Sec. 368(a)(1), the retention of the operative rules for reorganizations of the 1954 Code for qualified acquisitions, and the enactment of an explicitly elective taxing regime at the corporate level as proposed in the 1982 ALI Study and the Preliminary Staff Proposals would not involve substantial changes in what is permitted under the 1954 Code.

Andrews testified that enactment of these changes would, however, produce enormous simplification and would help to decouple questions of the legal form of the transaction and other matters of corporate procedure from tax treatment so that taxpayers would be spared the unproductive necessity of shaping transactions in possibly inconvenient forms to produce a chosen tax result. Andrews stated that making the corporate level tax treatment explicitly elective reduces the possibility of whipsaw, i.e., taxpayers taking mutually inconsistent positions, relying on interpretations of obscure aspects of the reorganization provisions, etc. See Id., at 69-70.

136/See generally Fuller, "Business Purpose, Sham Transactions And The Relaxation of Private Law To The Law Of Taxation" and Rice, "Judicial Techniques In Combating Tax Avoidance." In 1953, Rice stated that one of the most fundamental tax problems in the federal income tax law is the rationale or lack of rationale used by the courts to strike down tax avoidance devices and to refuse to recognize business arrangements which met the Code's literal requirements but which do not satisfy the spirit of the law. Rice also noted that the distinction between what the courts' permit as tax savings and forbid as tax avoidance are often made on conclusions that cannot be articulated other than to say "this taxpayer went too far." Rice, "Judicial Techniques In Combating Tax Avoidance" at 1025.

See also Levmore, "Recharacterizations And The Nature of Theory in Corporate Tax Law," 136 U. Pa. L. Rev. 1019 (1988).

137/366 U.S. 299 (1961), aff'g 279 F. 2d 354 (2nd Cir. 1960).

138/See Fuller, "Business Purpose, Sham Transactions And The Relaxation Of Private Law To The Law Of Taxation" at 388.

139/Id., at 355.

140/Id., at 397.

141/Id., at 355.

142/Id., at 388.

143/Id., at 387.

144/This fundamental issue is discussed in detail in Chapter IV of this Study. See generally Yin, "A Carryover Basis Asset Acquisition Regime?" A Few Words of Caution."

145/Leduc notes that because the corporate parties can explicitly elect whether a QA will be a cost or carryover basis acquisition, one of the objectives of the Act will be accomplished: whether the acquiring corporation acquires either the stock or the assets of the target corporation will generally be irrelevant in determining the corporate level tax consequences. Leduc notes that under the presumptions contained in the Act, the form of the acquisition will be of extreme importance only if the corporate parties have failed to make an intended cost basis or carryover basis election for a QA. See Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions And Dispositions: Substance and Process" at 46.

146/1983 Hearings on Reform of Corporate Taxation at 17.

147/1983 Hearings on Reform of Corporate Taxation at 17. As discussed in the text supra, many commentators feel the present law rewards well-financed and well-advised taxpayers who can hire sophisticated tax counsel in order to take advantage of the categorical distinctions between "reorganizations" and other types of acquisitive transactions.

148/1983 Hearings on Reform of Corporate Taxation at 18-19.

149/See Subchapter C Revision Act at 41.

150/See Westin, "In Like A Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse" at 999.

151/See Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions And Dispositions: Substance And Process" at 57. The repeal of the General Utilities doctrine may not strengthen this argument. The TRA of 1986 amended Sec. 336(c) to make it clear that new Sec. 336 does not apply to distributions of property if the recipient is eligible for tax-free treatment under Secs. 351 through 368. Thus the central issue is whether or not the consideration used must satisfy historic notions of continuity of interest in order to receive QA treatment.

152/Faber, "The Search for Consistency in Corporate Acquisitions" at 192. Faber notes that in replacing Sec. 334(b)(2) with Sec. 338 in 1982, Congress was concerned "about the failure of the gain recognition rules [applicable to the target corporation] to parallel the basis adjustment rules [the rules that allow the acquiring corporation to take a stepped-up basis in the target's assets with a Sec. 338 election]. Id. Faber also states:

> The consistency rules of Section 338 were viewed to some extent as being an attempt to reduce the revenue that was expected to be lost by the continued survival of General Utilities in the Section 338 context.

Id.

In a comment that is relevant to the corporation by corporation consistency rules contained in the Act for the acquisition proposals, Faber observes:

> Drafting consistency rules is a formidable task. In enacting Section 338, Congress chose to adopt a set of broad principles, leaving it up to the Treasury Department to provide detailed rules in regulations. The Treasury Department has responded to the chal-

> lenge with hundreds of pages of highly complex provisions. . . . Creative taxpayers can be expected to find many ways around them [the consistency rules]. Indeed, taxpayers can be expected to put pressure on any set of consistency rules in order to benefit from basis increases at the lowest possible cost.

Id., at 193.

In discussing the acquisition proposals in the Act, Faber states:

> The [Senate Finance Committee] Staff considered the consistency problem at some length and decided not to impose an affiliated groupwide consistency requirement. Instead, it concluded that consistency should be on a corporation-by-corporation basis. It was therefore not necessary to include stock consistency rules. Thus, under the Staff's proposal, a buyer could buy all of the stock of a target corporation from one corporate seller and all of the stock of a target affiliate of that target from the same seller, electing cost basis treatment for one of the two corporations and carryover basis treatment for the other. This would effectively restore the stock consistency world to its pre-TEFRA state.

Id., at 224.

153/As noted in the text supra, the Treasury Department also expressed its support for making the shareholder level tax consequences of an acquisition to each shareholder independent of the corporate level consequences and independent of the consequences to other shareholders. Thus a specific shareholder should not recognize gain or loss upon receipt of qualifying consideration from the acquiring corporation, regardless of any corporate level election made or the consideration received by other shareholders in a transaction constituting a qualified acquisition. See Hearings on Reform of Corporate Taxation at 13.

154/See Subchapter Revision Act at 41.

155/Id.

156/60 TC 218 (1973), aff'd 491 F2d 749 (3rd Cir. 1974). In this case, Mrs. Kass was a minority shareholder in the target corporation. Approximately 83 percent of the target's shareholders received cash from the acquiring corporation which merged the target into itself under 1954 Code

Sec. 334(b)(2). The acquiring corporation thereby obtained a stepped-up basis in the target's assets. Mrs. Kass argued that because she received only stock of the acquiring corporation, and no cash, she was entitled to tax-free treatment. The Tax Court held that the acquisition of the target and its liquidation into the acquiring corporation were all part of one transaction that failed to satisfy the continuity of interest requirement. Thus Mrs. Kass had to recognize all of her realized gain even though she only received stock of the acquiring corporation.

157/Subchapter C Revision Act at 41.

158/1983 Hearings on Reform of Corporate Taxation at 23-24.

159/1983 Hearings on Reform of Corporate Taxation at 112.

160/Id., at 214.

161/Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions" at 614.

162/Id. As discussed in Chapter IV of this Study, the "mirror basis" rules in which the acquiring corporation's basis in the target's stock will mirror the basis of the target's assets applicable to QSAs have been subject to much criticism. See, e.g., 1983 Hearings on Reform of Corporate Taxation at 281-282.

163/Id., at 613. If no stock of the acquiring group is received in a QAA or a QSA, the treatment is the same as under 1954 Code Sec. 331 in a liquidation following a Sec. 337 sale or under Sec. 1001 in the case of a stock sale. Id., at 614.

The Subchapter C Revision Act contains a limitation on the receipt of excess principal amount of securities in a QAA or a QSA which is very similar to that contained in current law. The result of these rules is that the receipt of an excess principal amount is treated as nonqualifying consideration and results in gain recognition to the recipient.

164/Id., at p. 613. The Final Proposals thus adopt the holding of Wright v. U.S., 482 F.2d 600 (8th Cir. 1973) and reject the holding of Shimberg v. U.S., 577 F.2d 577 (5th Cir. 1978). These cases are discussed in Milner, "Boot Under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction, but Too Far," 64 TAXES 507 (1984).

165/In order to provide such flexibility, the Act allows a target's assets or stock to be acquired in a qualified acquisition by any member of the affiliated group of the acquiring corporation.

166/78 Cong. Rec. Part 3 (H. R. 1934) at 2510.

167/1983 Hearings on Reform of Corporate Taxation at 9.

168/As discussed in Chapter I of this Study, many commentators have speculated on what event(s) caused the Wall Street crash of October 19, 1987 (so-called Black Monday in which the Dow Jones Industrial Average dropped over 508 points in one day). See, e.g., Clark, "Some Thoughts on the Stock Market Bubble of '87," Wall St. J. (December 12, 1987) at 22 (noting that no specific event occurred on October 19, 1987, which would account for this drop in the market index). A recent empirical study by two economists employed by the Securities and Exchange Commission suggests that the anti-takeover tax legislation being discussed by the House Ways and Means Committee on Tuesday, October 13, 1987, (which would have limited deductibility of interest expense in hostile takeovers and otherwise reduced the tax incentives for debt-financed acquisitions because, in the words of the Committee, "corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy")" is the leading candidate as a major catalyst that triggered the crash." Ricks, "SEC Economists Closely Link Tax Action By Ways and Means Panel to 1987 Crash," Wall St. J. (May 4, 1989) at C13. See also "The Market's Maginot Line," Wall St. J. (May 10, 1989) at A22 (editorial noting that the stock market may again react in an adverse manner if "Congress, in the name of stopping takeovers and restructurings, threatens to turn the tax code into a giant poison pill").

169/See, e.g., Murray, "Treasury Agency Backs Away From Plan For Use of Tax Code to Discourage LBOs," Wall St. J. (May 17, 1989) at A2 (noting the Treasury Department opposition to suggestions to limit the deductibility of interest expense and make dividends partly deductible in order to limit incentives for leveraged buy-outs and other debt-financed takeovers because "Treasury has looked at it and can't find a way to do it").

170/1983 Hearings on the Reform of Corporate Taxation at 28.

171/1985 Hearings on Reform of Corporate Taxation at 328-329.

Endnotes--Chapter IV

1/See the discussion in Chapter III of this Study.

2/See American Institute of Certified Public Accountants, Statement on Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises (1979) (hereafter 1979 AICPA Study).

3/See American Law Institute, Federal Income Tax Project Subchapter C Tentative Draft No. 1 (1977) (hereafter 1977 ALI Study); American Law Institute, Federal Income Tax Project (1980) (hereafter 1980 ALI Study); and American Law Institute, Federal Income Tax Project Subchapter C--Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions (hereafter 1982 ALI Study). The 1977 and 1980 ALI studies are discussed in Beghe, "The American Law Institute Subchapter C Study: Acquisitions and Dispositions," 33 Tax Law. 743 (1980) and in the 1982 ALI Study.

There have been numerous broad and narrow attempts to reform the provisions of Subchapter C governing acquisitive transactions. Some commentators believe the current reform effort which is most relevant to this Study, i.e., the creation of the proposals for acquisitive transactions contained in the Subchapter C Revision Act, commenced on October 28, 1982. Senator Robert Dole, then Chairman of the Senate Finance Committee, announced in a press release that he had directed the staff of the Senate Finance Committee, with the assistance of the staff of the Joint Committee on Taxation, to study recent proposals to revise the tax treatment of corporate acquisitions, mergers, dispositions, net operating losses, and related issues concerning the taxation of corporations and shareholders. See Staff of the Senate Finance Committee, 98th Cong., 1st Sess., The Subchapter C Revision Act of 1985 (S. Prt. 99-47 1985) (hereafter Subchapter C Revision Act) at v.

The press release specifically states that the proposals of the American Law Institute and the American Bar Association relating to Subchapter C should be carefully examined as part of the staff of the Senate Finance Committee's study. The press release issued by Senator Dole stated:

> I believe that sophisticated taxpayers are still able [after the enactment of TEFRA] to obtain unintended benefits in certain complex corporate transactions. Moreover, the enormous complexity of the current cor-

porate tax law puts unintended burdens on honest taxpayers.

Id.

Prior to the commencement of the Senate Finance Committee's study of Subchapter C which resulted in the issuance of Preliminary Staff Proposals in September 1983, the Executive Committee of the New York State Bar Association Tax Section met with the staff of the Senate Finance Committee to discuss the scope of the Subchapter C study. The Executive Committee statement was reported as "New York Bar Association Memorandum for Staff of the Senate Finance Committee on Corporate Acquisitions, Net Operating Losses and Related Issues" (January 19, 1983) in BNA Tax Reporter, Background Material (IV-10, 98th Cong.) at BM-107.

The Executive Committee told the staff members that any attempt at major structural reform of Subchapter C must address two major tax policy issues: integration of the corporate and shareholder level taxes and the role of the 1954 Code provisions codifying the General Utilities doctrine. Most commentators agree that proposals to integrate the corporate and shareholder taxes and proposals to repeal the General Utilities doctrine would be highly controversial. See Id.

The Executive Committee also suggested:

1. Congress should undertake a comprehensive study of Subchapter C with a view to making major structural reform. The Executive Committee felt there was little value in performing another "patchwork" study due to the interrelated nature of major Subchapter C problems.

2. A major study of all the existing Subchapter C problems must be given substantial time for development and comment. The Executive Committee stated that at least two years should be devoted to the preparation of the study and careful and deliberate consideration of it by all interested parties.

The Committee stated that a study of Subchapter C conducted in haste (i.e., in the manner in which several of the recent major tax bills have been enacted by Congress), could result in a tax law which would be substantially worse that the existing 1954 Code provisions. See Id., at BM-108.

4/See Comm. on Finance, The Reform and Simplification Of The Income Taxation of Corporations, 98th Cong., 1st Sess. (S. Prt. 98-95 1983) (hereafter Preliminary Staff Proposals). The final report of the staff of the Comm. on Finance was issued as the Subchapter C Revision Act. The 1982 ALI Study and the Preliminary Staff Proposals agree on all major elements of the acquisition proposals. See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process," 22 San Diego L. Rev. 17 (1985). The Preliminary Staff Proposals and the final proposals contained in the Subchapter C Revision Act are similar in all material respects. See Thompson, "A Comparison Of The Merger and Acquisitions Proposals Of Present Law With The Provisions In the Senate Finance Committee's Draft Bill," 22 San Diego L. Rev. 171 (1985).

5/See Reform of Corporate Taxation: Hearings Before the Comm. on Finance, 98th Cong., 1st Sess. (S. Hrg. 98-556 1983) (hereafter 1983 Hearings on Reform of Corporate Taxation); Staff Recommendations to Revise Subchapter C: Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance, 99th Cong., 1st Sess. (S. Hrg. No. 99-506 1985) (hereafter 1985 Hearings on Reform of Corporate Taxation); Staff of the Joint Comm. on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions: Hearings before Subcomm. on Oversight and the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means (Joint Comm. Print 1985) (hereafter Tax Aspects of Mergers and Acquisitions); and Staff of the Joint Comm. on Taxation, Federal Income Tax Aspects of Hostile Takeovers And Subcomm. on Taxation and Debt Management of the Comm. on Finance (Joint Comm. Print 1985) (hereafter Report on Hostile Takeovers).

6/See Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hearings Before the Comm. on Ways and Means (Joint Comm. Print 1984) (hereafter 1984 Comprehensive Tax Reform Proposals); Staff of Joint Comm. on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform: Hrgs. Before the Comm. on Ways and Means (Joint Comm. Print 1985) (hereafter 1985 Comprehensive Tax Reform Proposals); and Tax Reform: A Staff Study Prepared For The Use Of The Subcomm. on Economic Goals And Intergovernmental Policy of the Joint Economic Comm., 98th Cong., 2nd Sess. (S. Prt. 98-253 1984) (hereafter Joint Economic Committee Study).

For a general discussion of comprehensive tax reform issues, see Bradford, Untangling the Income Tax (Harvard University Press, 1986).

7/See generally Krane, "Current Problems in Acquisitive Reorganizations," 51 TAXES 737 (1973); Faber, "The Search for Consistency in Corporate Acquisitions," 13 J. Corp. Tax'n 187 (1987); Ginsburg, "Special Topics in the Acquisitions Area," 22 San Diego L. Rev. 159 (1985); Ginsburg, "Taxing Corporate Acquisitions," 38 Tax L. Rev. 171 (1983); Jacobs, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (1980); and Walter, "Unwanted Assets in Taxable and Tax-Free Corporate Acquisitions: Old Wine in New Bottles," 63 TAXES 897 (1985).

8/The tax literature contains detailed discussions of both the Preliminary Staff Proposals and the final acquisition proposals. See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process"; Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web," 133 U. Pa. L. Rev. 1335 (1985); Shaw, "Impact Of Proposals On Acquisitions Of Closely Held Corporations," 22 San Diego L. Rev. 289 (1985); Faber, "Taxation Of Corporations And Shareholders: Premises Of The Present System." 22 San Diego L. Rev. 5 (1985); Ginsburg, "Special Topics In The Acquisitions Area"; Thompson, "A Comparison Of The Merger and Acquisitions Proposals Of Present Law With The Provisions In the Senate Finance Committee's Draft Bill"; and Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions," 5 Va. T. Rev. 599 (1986).

9/The major criteria utilized are equity, economic efficiency, simplicity, and stimulation of specific activities. See 1984 and 1985 Comprehensive Tax Reform Proposals. For an analysis of the Tax Reform Act of 1986 using these traditional tax policy criteria, see Holtz-Eakin, "The Tax Reform Act of 1986: Simplicity, Equity, and Efficiency," 4 Akron Tax J. 69 (1987). Holtz-Eakin (at 73) asserts that the TRA of 1986 is significant because it reaffirmed the use of an income tax in the United States as a permanent part of economic policy.

10/See Faber, "Taxation of Corporations and Shareholders: Premises of the Present System."

11/Two fundamental tax policy issues in evaluating the General Utilities doctrine and, more broadly, the taxation of acquisitive transactions are defining "taxable income" at the corporate level and specifying more exactly which events constitute a realization of income at the corporate level in the context of acquisitive transactions and complete liquidations. See Brannon, "Tax Loopholes As Original Sin: Lessons From Tax History," 31 Vill. L. Rev.

1763 (1986) at 1773 (asserting that many taxpayers have come to rely on the improper treatment of unrealized gain allowed by General Utilities); Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1339 (asserting that determining which events do and do not constitute a realization of gain at the corporate and shareholder levels in acquisitive transactions is the central tax policy issue which must be resolved); and the 1982 ALI Study at 15 (stating "The true subject of the Acquisition Proposals . . . is [determining] what is to be done about previously untaxed gains and undeducted losses [of the target corporation in acquisitive transactions]").

12/See United States Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: Volume 1--Overview; Volume 2--General Explanation of the Treasury Department Proposals; and Volume 3--Value Added Tax (November 1984) (hereafter Treasury I).

13/See United States Government Printing Office, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) (hereafter Treasury II).

14/P. L. 99-154, 100 Stat. 2085 (October 22, 1986). See generally Harris, "A Brief History of the Tax Reform Act of 1986," 1 Prac. Tax Law. 1 (1987) and Eustice, Kuntz, Lewis, and Deering, The Tax Reform Act of 1986 Analysis and Commentary (Warren, Gorham & Lamont, Inc., 1987).

15/Pub. L. No. 100-203, 101 Stat. 1330 (1987).

16/See Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative," 31 Vill. L. Rev. 1665 (1986).

17/See 1983 and 1985 Hearings on Reform of Corporate Taxation.

18/1979 AICPA Study at 1. See generally Benston, Conglomerate Mergers (American Enterprise Institute for Public Policy Research, 1980) and Steiner, Mergers: Motives, Effects, Policies (University of Michigan Press, 1975). The AICPA (at 1-2) also states:

> As a matter of public policy, the importance of the continued formation of new corporate businesses has been and continues to be widely recognized. Few subjects, however, have given rise to more heated controversy than has that of corporate mergers and their economic impact. The debate focuses upon two primary issues: the effect of business combinations on the

> competitive structure and the degree of industrial concentration in the American economy, and, to the extent that mergers and acquisitions explain the size of larger businesses, the nature and the effect of the resultant business power exercised by these firms over markets and consumers. The positions taken by responsible commentators on each of these issues vary widely from one extreme to the other.

19/Sommerfeld, Federal Taxes and Management Decisions (Richard D. Irwin, 1985) at 254-255. Sommerfeld also notes that under the 1954 Code, the double tax regime was often not a major consideration for many closely-held corporations. The principal reasons include: the shareholder-employees could often take out most of pre-tax corporate profits as deductible salaries, rents or interest payments and any remaining corporate income (i.e., that in excess of the owner's personal needs), could be accumulated in the corporate shell, where it expanded through new and larger business investments. Well-advised shareholders could then utilize the tax-free reorganization provisions advantageously:

> If the owner does not die sooner, and if he or she does not desire the control of the corporation to pass to another member of the family, the owner typically allows the firm to be reorganized as part of a larger venture in a nontaxable transaction. Finally, then, the stock of either the original company or of the merged corporation is passed on to the heirs or devises who inherit the property with a basis equal to the stock's value on the date of the decedent's death. Thus, the accumulated income is never 'realized' by the family; instead, the personal income tax has been permanently deferred.

Id.

20/See Report on Hostile Takeovers at 3.

21/See generally Bittker, "A Comprehensive Tax Base as a Goal of Income Tax Reform," 80 Harv. L. Rev. 915 (1967). The Council of Economic Advisers states:

> The concept of a pure income tax system provides a useful benchmark for assessing the current tax system and proposals for tax reform.

Annual Report of the Council of Economic Advisers (Feb. 1985) at 77. The Council states that deviations from a pure income tax system have arisen for these reasons:

1. Explicit decisions to subsidize a particular activity through the tax system.

2. Explicit decisions to maintain equity when "income" is not an adequate measure of the taxpayer's ability to pay taxes.

3. Explicit decisions not to implement a pure income tax system due to administrative and measurement problems.

See Id., at 78.

22/An income tax system encourages investment in tax exempt activities and activities subject to a relatively low effective tax rate and discourages investment in activities subject to a relatively high tax rate. See Annual Report of the Council of Economic Advisers (Feb. 1985) at 68 and 77. The economic literature uses the term "marginal excess burden" to describe the additional costs (i.e., the so-called allocative costs) of the misallocation of resources (i.e., deviations from the allocation of resources in a world without taxes) which occur as a result of taxing policies. Empirical studies suggest that allocative costs differ in alternative tax regimes and that such costs increase sharply and directly with increases in marginal tax rates. See Stuart, "Welfare Costs per Dollar of Additional Tax Revenue in the United States," 74 Am. Econ. Rev. 352 (1984) and Gordon, "Taxation of Corporate Capital Income: Tax Revenues Verses Tax Distortion," 100 Q. J. of Econ. 1 (1985).

Holtz-Eakin offers the following example of allocative costs in a business context under the 1954 Code:

> To the extent that otherwise identical projects deliver returns in different proportions of [ordinary] income and capital gain, the effective tax rates will differ. Similarly, those projects which receive relatively generous depreciation allowances or investment tax credits are more attractive. The differential tax treatment of otherwise identical capital investments causes losses to society due to the inappropriate allocation of investment funds. This misallocation is not the 'fault' of the decision maker, it is the direct result of the tax-induced incentives presented to individuals.

Holtz-Eakin, "The Tax Reform Act of 1986: Simplicity, Equity, and Efficiency" at 79.

23/<u>See generally</u> Doernberg and McChesney, "On The Accelerating Rate And Decreasing Durability of Tax Reform," 71 Minn. L. Rev. 913 (1987). Hickman notes that Congress has enacted twenty major tax bills between 1948 and 1984. See Hickman, "Evolution of a New System," Federal Tax Policy Memo (Tax Foundation, Nov/Dec. 1986). Hickman believes the following factors are primarily responsible for the frequency and severity of major changes in the Internal Revenue Code:

1. The phenomenon of bracket creep and the resulting fiscal dividend (i.e., the automatic increase in tax revenue to the federal government caused by the combination of inflation and the progressive income tax system).

2. Increased use of the federal income tax laws to promote economic growth rather than to redistribute income, particularly during the Reagan administration.

These issues is discussed in Kristol, "The Reagan Revolution That Never Was," Wall St. J. (April 19, 1988) at 26 and Hibbs, The American Political Economy (Harvard University Press, 1986) at 326.

3. The "breeder reactor" effect: changes in the technical provisions of the Code proliferate in a self-generating manner.

4. The increased influence of political action committees coupled with the popularity of "tax reform" with Congressmen who believe that "tax reform" has mass voter appeal.

5. The need to increase the yield of the corporate income tax.

This issue is discussed in Ture and Egger, "Corporations' Fair Share Of Federal Taxes," 39 Tax Notes 1337 (June 13, 1987) and Auerbach and Poterba, "Why Have Corporate Tax Revenues Declined?" in Summers (ed.), Tax Policy and the Economy (MIT Press, 1987) at 1-28.

24/See 1985 Comprehensive Tax Reform Proposals at 34 (statement of Robert Kavner, Senior Vice President and Chief Executive Officer, American Telephone and Telegraph Corporation). The possibility of windfall gains or losses arising from major changes in the tax laws is addressed in Downs and Hendershott, "Tax Policy and Stock Prices," XL Nat'l Tax J. 183 (1987).

25/See 1985 Comprehensive Tax Reform Proposals at 54-55 (statement of John Motley, Director of Federal Legislation of the National Federal of Independent Businesses, arguing that simplicity and stability should be the paramount objectives of the comprehensive tax reform effort).

26/See 1985 Comprehensive Tax Reform Proposals at 37-41 (statements by the head of the ABA Section on Taxation and the head of the Tax Division of the AICPA noting the frequency and severity of major changes in the tax law in the 1980s has placed many burdens on taxpayers and tax professionals). See also Lodge, "A Tax System Out Of Control," 165 J. Acct. 132 (1988) (asserting that even full-time tax professionals cannot keep up with the frequent and major changes in the tax laws in the United States).

27/See Annual Report of the Council of Economic Advisers (Feb. 1985) at 83.

28/See 1985 Comprehensive Tax Reform Proposals at 8.

29/See Brannon, "Tax Loopholes As Original Sin: Lessons From Tax History" and Pechman, Federal Tax Policy (The Brookings Institution, 5th Ed., 1987) at 79. Pechman states:

1. Erosion of the tax base puts a premium on earning and disposing of income in forms that receive preferential treatment which, in turn, often distorts the allocation of resources which would occur in a no tax world.

2. Erosion of the tax law violates the principle of horizontal equity (i.e., taxpayers with equal economic incomes should pay the same amount of tax).

3. Arbitrary departures from vertical and horizontal equity contribute to taxpayer dissatisfaction and create pressures for the enactment of additional "tax loopholes" and special provisions.

McClure states:

> Tax reform has historically been a liberal cause motivated by the desire to increase the overall progressivity of the tax system by reducing or eliminating provisions that are especially advantageous to upper-income individuals and corporations.

McClure, "Where Tax Reform Went Astray," 31 Vill. L. Rev. 1619 (1987) at 1642.

30/A discussion of the variation in effective tax rates for various industries and types of assets and financing arrangements under the 1954 Code is contained in Auerbach, "The Corporation Income Tax" in Pechman (ed.), The Promise of Tax Reform (Prentice Hall, 1985) at 86-90.

31/The Council of Economic Advisers states that eliminating the substantial bias against saving and investment should be a major focus of comprehensive tax reform efforts. See Annual Report of the Council of Economic Advisers (Feb. 1985) at 80.

32/See Annual Report of the Council of Economic Advisers (Feb. 1985) at 77-78. Empirical studies suggest that taxpayer behavior is often quite sensitive to the level of marginal tax rates. See Lindsey, "Tax Reform and Taxpayer Behavior," 39 Tax Notes 1349 (June 13, 1988). Lindsey notes that two basic themes have driven the frenzied pace of tax legislation in the 1980s in the United States: (1) the growing realization that high marginal tax rates significantly alter taxpayer behavior; and (2) disinclination to use the income tax laws to favor certain types of economic activity.

See also Lindsey, "Capital Gains Rates, Realizations, and Revenues," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation (University of Chicago Press, 1987) at 69-100; Lindsey, "Estimating the Behavioral Response to Changes in Tax Rates: 1982-1984, with Implications for the Revenue-Maximizing Tax Rate," 33 J. Pub. Econ. 173 (1987); Todder and Ozanne, "CBO Works On Capital Gains," 39 Tax Notes 1441 (June 209, 1988); Minarik, "The New Treasury Capital Gains Study: What Is In The Black Box?" 39 Tax Notes 1465 (June 29, 1988); and Kiefer, "Capital Gains Response To Tax Rate Changes," 39 Tax Notes 1445 (June 20, 1988).

33/See 1985 Comprehensive Tax Reform Proposals at 1.

34/See Id., at 2 (statement of James Ferguson, Chairman of the Board and Chief Executive Officer General Foods Corporation, asserting that the 1954 Code often violated these principles). See also Id., at 3 (statement of John Huck, President and Chief Executive Officer of Merck & Co).

35/See Steuerle, "The New Tax Law" in Cagan (ed.), Deficits, Taxes, and Economic Adjustments (American Enterprise Institute for Public Policy Research, 1987) at 276.

36/See Id.

37/See Id., at 275-292.

38/See Pechman, Federal Tax Policy at 131-132. Pechman also asserts that the provisions of the 1986 Code are very likely to be modified by experience, particularly in the area of removing incentives for saving and investment. See Id., at 4. Pechman states the TRA of 1986 will improve the corporate tax law by measuring and taxing corporate income in a much more uniform manner than was the case under the 1954 Code.

39/See Simmons, "The Tax Reform Act of 1986: An Overview," 1987 B.Y.U.L. Rev. 151 (1987).

40/See Feldstein, "Imputing Corporate Tax Liabilities To Individual Taxpayers," XLI Nat'l Tax J. 37 (1988). Uncertainty about the incidence of the corporate tax coupled with uncertainties about the distributional consequences of changes in the corporate income tax law on individual taxpayers make this type of analysis very difficult. See also Harberger, "The Incidence of the Corporate Income Tax, " 76 J. of Pol. Econ. 315 (1962) and Feldstein and Slemrod, "Personal Taxation, Portfolio Choices and the Effect of the Corporate Income Tax," 88 J. of Pol. Econ. 5 (1980).

41/See Stiglitz and Wolfson, "Taxation, Information, and Economic Organization, " 9 J. Am. Tax'n A. 19 (1988).

42/See Ernst & Whinney, Tax Reform--1986 at 1.

43/Annual Report of the Council of Economic Advisers (Jan. 1987) at 96 and at 65.

44/See Id., at 65.

45/See Id., at 83.

46/See Id., at 84-85.

47/See Id., at 65-66. See also Fullerton and Henderson, "The Impact of Fundamental Tax Reform on the Allocation of Resources" in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 401-443.

48/See Id., at 85-86.

49/See Annual Report of the Council of Economic Advisers (Jan. 1987); Ben-Horin, Hockman and Palmon, "The Impact of the 1986 Tax Reform Act on Corporate Finance Policy," 16 Fin. Mgmt. 29 (1987); Buchanan, Rowley, and Tollison (eds.), Deficits (Basil Blackwell, 1987); Cagan (ed.), Deficits, Taxes, and Economic Adjustments; Crimm and Brenneman, "Tax Sheltering of Income: Passive Loss Rules Under The Tax Reform Act of 1986," 4 Akron Tax J. 101 (1987); Downs and Hendershott, "Tax Policy and Stock Prices"; Feldstein (ed.), The Effects of Taxation on Capital Accumulation; Feldstein, "Imputing Corporate Tax Liabilities To Individual Taxpayers"; Greenspan, "The New Tax Law: The Future of Private Enterprise and Entrepreneurship," 4 Akron Tax J. 61(1987); Hibbs, The American Political Economy; Holtz-Eakin, "The Tax Reform Act of 1986: Simplicity, Equity, and Efficiency"; Green, "The Impact of the Tax Reform Act of 1986 on Personal Investments," 4 Akron Tax J. 83 (1987); Pechman, Federal Tax Policy (1987); and Summers (ed.), Tax Policy and the Economy.

50/Pechman, Federal Tax Policy (1987) at 171.

51/Zolt asserts that the repeal of General Utilities focused on the principal, and most publicized, aspects of the corporate level nonrecognition provisions of the 1954 Code. Congress thus became very concerned about charges of asymmetry (i.e., the ability of an acquiring corporation to obtain a step-up in basis in the target's assets coupled with a permanent exemption from taxation on much of the gain realized at the target corporation level), tax-motivated transactions, and erosion of the corporate tax base. See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal," 65 TAXES 819 (1987) at 819-821.

52/See Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future," 46 Inst. on Fed. Tax'n (1987) at 37-77. Leduc and Gordon state that the corporate alternative minimum tax provisions were a less important structural change in Subchapter C than was the repeal of the General Utilities doctrine. See Id., at 37-17.

Yin notes that the complete repeal of General Utilities, tempered only by some liberal transitional rules, surprised and startled many astute observers of the tax legislative scene. Yin concludes that the repeal of General Utilities was a "remarkable" event in view of the circumstances under which the TRA of 1986 was enacted. See Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986," 42 Tax L. Rev. 575 (1987) at 576. Yin concludes that ultimately, General Utilities was not repealed as an antiabuse measure but as a way to pay for the retention of certain oil and gas tax preferences. See Id., at 581.

53/The Subchapter C Revision Act was issued in May 1985 and Congressional hearing were held on the Act in September 1985. See 1985 Hearings on Reform of Corporate Tax-
ation. The acquisition proposals were thus available to Congress during the legislative process which resulted in the enactment of the Tax Reform Act of 1986 in October 1986 but were not enacted. Both Chapters IV and V of this Study explore the tax policy and political reasons the acquisition proposals were not enacted in the TRA of 1986 or the Revenue Act of 1987. See generally Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future."

54/See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process" at 66 and Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future" at 37-152.

55/See Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions And Dispositions: Substance And Process" at 66. As discussed in Chapters III and IV of this Study, many commentators note that because the shareholders can only receive stock of the acquiring corporation tax-free in a qualified acquisition, the corporate and shareholder level consequences of qualified acquisitions are not completely unlinked.

56/Id., at 66-67.

57/Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986" at 577.

58/See generally Kotlarsky, "Stepping Up Basis: Purchase of Stock or Purchase of Assets," 39 Tax Notes 1101 (May 30, 1988); Unger, "Gain Recognition and Basis in Acquisitions," 45 Inst. on Fed. Tax'n (1987) at 3-1; and Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution," 37 Tax Notes 415 (1987).

59/See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium," 66 N. C. L. Rev. 839 (1988).

60/As discussed in Chapter III of this Study, the 1986 Code encourages carryover basis transactions while the

1954 Code encouraged taxable acquisitions on a present value basis. Zolt asserts that the elimination of lower tax rates for long-term capital gains will cause corporate and individual taxpayers to use the deferred recognition techniques (e.g., the tax-free reorganization provisions) contained in the Code in attempts to minimize taxes for the following reasons:

1. Elimination of lower tax rates for recognized long-term capital gains increases the shareholder level cost of taxable sales of corporate stock.

2. Lower corporate tax rates reduce the tax savings available to the acquiring corporation from stepped-up basis (i.e., taxable) transactions.

3. Repeal of the General Utilities doctrine will generally require the immediate payment of taxes in taxable purchases of target corporation assets and in Sec. 338 transactions.

See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium" at 871-873.

See Bloom, "Buying and Selling Corporations After Tax Reform," 14 J. Corp. Tax'n 167 (1987); Bonovitz, "Impact of TRA Repeal of General Utilities," 65 J. Tax'n 388 (1986); Brode, "General Utilities Repeal: A Transactional Analysis," 66 J. Tax'n 322 (1987); Faber, "Capital Gains v. Dividends: Is The Battle Still Worth Fighting?" 64 TAXES 865 (1986); Knight and Knight, "Merger Mania: Did the Tax Reform Act of 1986 Reduce the Tax Incentives for Corporate Takeovers, Mergers and Acquisitions?" 40 Tax Exec. 79 (1987); Lobenhofer, "The Repeal of General Utilities for Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform," 4 Akron Tax J. 153 (1987); Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics Not Being Basic," 14 J. Corp. Tax'n 203 (1987); Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986"; and Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal."

61/See generally Brode, Tax Planning for Corporate Acquisitions (Prentice Hall/Posenfeld Launer Pub., 1988).

62/See, e.g., Buchanan, "Budgetary Bias in Post-Keynesian Politics: The Erosion and Potential Replacement of Fiscal Norms" in Buchanan, Rowley, and Tollison (eds.), Deficits. Buchanan states:

> Policy advocacy must always be placed squarely in a political setting, and it must be cognizant of the incentive structure that faces persons in their varying public choosing roles, as voters, as party leaders, as elected politicians, and as bureaucrats.

Id., at 192.

Political forces and public choice economics can explain some taxing policies which seem to have near universal appeal among politicians. Lee, for example, notes that even in the absence of explicit budget deficits, politicians often concentrate much of their spending on special interest programs paid for by broad-based taxes. This taxing policy often allows politicians to reap political benefit far in excess of the net social benefits provided by the special interest programs.

See Lee, "Deficits, Political Myopia, and the Asymmetric Dynamics of Taxing and Spending," in Buchanan, Rowley, and Tollison (eds.), Deficits at 289-290. Lee's analysis is interesting because it demonstrates how politicians can often convince voters that the government can provide social benefits at little or no apparent cost to the government. Lee states that " . . . every government benefit has to be paid for ultimately with some form of tax on the public." Id., at 290. Lee notes that the political myopia of the budgetary process, the latitude enjoyed by politicians in structuring spending and taxing policies, inflation, and financing social programs through deficit financing often allows politicians to create and maintain the illusion that they are dispensing more net benefits to their constituents than they really are. See Id., at 289-293.

In spite of the concern expressed about lack of symmetry, the tax-motivated transactions created to take advantage of the corporate level nonrecognition of gain provisions, and the integrity of the double tax system for corporate income, several commentators believe the repeal of General Utilities in the TRA of 1986 can be must fulled accounted for by Congress' need to raise revenue from corporations in order to help "pay for" the reduction in marginal tax rates for individual taxpayers. See, e.g., Simmon, "The Budget Process And The Tax Law," 40 Tax Notes 627 (August 8, 1988). Simmon suggests that the 1984 decision to create a new tax expenditure provision for the General Utilities doctrine and increased Congressional concern about the low yield of the corporate income tax played a role in the ultimate repeal of the doctrine.

63/Alan Greenspan, Chairman of the Federal Reserve Board, states that in the United States, the federal income tax laws demonstrate our political values that marginal tax rates, exemptions, tax preferences, and level of enforcement of the tax laws all reflect the philosophical glue of our political system. See Greenspan, "The New Tax Law: The Future of Private Enterprise Entrepreneurship," 4 Akron Tax J. 61 (1987) at 67.

Because the imposition of high marginal tax rates on individual taxpayers has been so deeply imbedded in the United States since World War II as an ethical principle, Greenspan concludes the significant reduction in marginal tax rates in the TRA of 1986 was an extraordinary political event. See Id., at 62.

64/Consideration of the technical aspects of the tax law are commonly acknowledged to be an important part of the comprehensive tax reform efforts. One of the basic goals of comprehensive tax reform efforts as described in Treasury I and Treasury II was to make the federal income tax law less economically inefficient. Stated differently, a principal goal of comprehensive tax reform efforts is to reduce the influence of the tax law in private and corporate decision making and to make the tax law more neutral. See generally 1984 and 1985 Comprehensive Tax Reform Proposals.

Yin notes that the acquisition proposals are controversial principally because they call for major changes in the 1954 Code (e.g., the repeal of General Utilities) and the liberalization of the tax law (i.e., allowing the operative provisions for tax-free acquisitive reorganizations to apply to a much broader set of acquisitive transactions than "tax-free reorganizations"). See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution."

65/1985 Comprehensive Tax Reform Proposals at 34.

66/The Joint Committee on Taxation has cautioned Congress and other policy makers not to enact changes in the tax laws too quickly in response to the high volume of merger activity or to overreact to the novel offensive and defensive tactics employed in takeover contests in the 1980s. The Joint Committee states:

> 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 is deemed proper, Congress could amend the securities laws to regulate certain takeover tactics. In ad-

> dition, 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 interests through the courts.

Report on Hostile Takeovers at 15.

67/See generally Easterbrook and Fischel, "Corporate Control Transactions," 91 Yale L. J. 698 (1982). The Joint Committee on Taxation states:

> 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.

Tax Aspects of Mergers and Acquisitions at 14.

68/See generally Bork, The Antitrust Paradox (Basic Books, Inc., 1978); Demseta, "The Trust Upon Which Antitrust Stands," 46 Antitrust L. J. 821 (1977); Horowitz, The Irony of Regulatory Reform (Oxford University Press, 1989); and Hovenkamp, "Antitrust Policy after Chicago," 82 Mich. L. Rev. 213 (1985).

69/See generally Adams and Brock, The Bigness Complex (Pantheon Books, 1986) and McGill, American Business and the Quick Fix (Henry Holt & Co., 1988).

70/See generally Lipton, "Corporate Governance In The Age of Finance Corporatism," 136 U. Pa. L. Rev. 1 (1987) and Report of the Chairman of the Subcomm. on Telecommunications, Consumer Protection, and Finance of the Comm. on Energy and Commerce (U.S. House of Representatives), Corporate Takeovers: Public Policy Implications For The Economy and Corporate Governance, 99th Cong., 2d Sess. (Comm Print 99-QQ 1986).

71/See generally Drucker, The Frontiers of Management (E.P. Dutton, 1986) and Waterman, The Renewal Factor (Bantam Books, 1987).

72/See Haugen and Senbet, "Corporate Finance and Taxes: A Review," 15 Fin. Mgmt. 5 (1986) and Ferris and Reichenstein, "A Note On The Tax-Induced Clientele Effect And Tax Reform," XLI Nat'l Tax J. 131 (1988).

73/The Joint Committee on Taxation states that the 1954 Code did not distinguish between friendly and hostile takeovers, did not intentionally encourage or discourage hostile acquisitions, and generally provided the same tax law for large publicly-held and small closely-held corporations. See Report on Hostile Takeovers at 4.

74/In discussing the megamerger wave in the United States in the 1980s, Davidson asserts that "ideas count" and that top executives of large publicly-held corporations are influenced by certain ideas and trends. Because business decisions are frequently made in absence of complete knowledge, fads recur in the business community. See Davidson, Megamergers (Ballinger Pub. Co., 1985) at 239.

Davidson argues that the megamerger boom was caused by a number of factors including:

1. The promise of profits through merger was overenthusiastically accepted.

2. The wave of offensive mergers produced waves of defensive mergers.

3. The process fed on itself. Defensive mergers added to the perception that mergers were profitable and that they were necessary to preserve independence. Thus more mergers produced more urgency to merge. See Id., at 239.

Davidson notes that megamergers may be similar to other fads:

> Vertical integration, international expansion, automation, and consumer hot lines have all had their moment as the best new idea for businesses to adopt. All made sense for some businesses at some time. And each has died out as a fad when more was learned about the appropriate limits to the usefulness of the new technique.

Id.

Davidson notes that business strategists and consultants have developed rationales for virtually every type of investment option open to management. Certain strategies actively promote the notion that mergers and acquisitions are beneficial to the acquiring corporation. See Id., at 171-173.

The "investment matrix" concept created and popularized by Bruce Henderson, Chief Executive of the Boston Consulting

Group, is one of the most frequently used justifications for undertaking corporate acquisitions. See Henderson, Henderson on Corporate Strategy (Belknap Press, 1979).

Henderson offered the following four-part justification for an acquiring corporation undertaking mergers and acquisitions:

1. successful firms have a life cycle;
2. during their mature phase, successful firms generate excess earnings that can most appropriately be used to acquire other firms;
3. appropriate target firms can be identified; and
4. capable executives can manager the resulting conglomerate firms.

75/See generally Auerbach (ed.), Corporate Takeovers: Causes and Consequences (The University of Chicago Press, 1988); Benston, Conglomerate Mergers: Causes, Consequences, and Remedies; Bernake and Campbell, Brookings Papers on Economic Activity I (The Brookings Institution, 1988); Feldstein (ed.), The Effects of Taxation on Capital Accumulation; and Steiner, Mergers: Motives, Effects, Policies.

76/See Report on Hostile Takeovers at 71.

77/See generally Krinsky, Rotenberg, and Thornton, "Takeovers--A Synthesis," 7 J. Acct. Lit. 243 (1988).

The special deductions allowed to individual taxpayers for contributions to Individual Retirement Accounts (IRAs) under the 1954 Code have been severely limited for most higher income taxpayers under the 1986 Code. See McConnell, "Highlighting the Tax Reform Act of 1986 for individuals," 17 Tax Adviser 616 (1986); Coppage, "IRAs after the Tax Reform Act of 1986: To contribute or not to contribute?" 39 Tax'n for Acct. 54 (1987); and Venti and Wise, "IRAs and Saving," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 7-51.

Many commentators believe that because the IRA provisions encouraged savings and satisfied the generally accepted objectives of the federal income tax system, Congress should not have made the changes which were made in the Tax Reform Act of 1986. Other commentators, however, would have completely eliminated deductions for contributions to IRAs for all taxpayers because the IRA provisions:

> . . . have failed to generate substantial retirement savings, and its only significant effect has been to

provide a tax haven for upper income taxpayers. Like many other incentive programs that have been incorporated into the Internal Revenue Code, the IRA inefficiently reduces federal revenues while undermining the progressivity of the graduated income tax. To overcome these defects, Congress should replace the IRA tax incentive with a direct subsidy for retirement savings.

Note, "Costs and Consequences Of Tax Incentives: The Individual Retirement Account," 94 Harvard L. Rev. 864 (1981) at 864.

78/The acquisition proposals attempt to define the scope of the double tax system more coherently for acquisitive transactions. See 1977 ALI Study at 9.

79/Pechman's comments about the corporation income tax in the United States are representative:

> The corporation income tax has been subject to a continuous barrage of criticism on economic grounds. The most critical issues are its effects on investment and saving, equity and debt finance, resource allocation, built-in flexibility, and the balance of payments. The charges and countercharges reflect different assumptions about who bears the tax and the inherent difficulty of separating the effect of taxation from other factors.

Pechman, Federal Tax Policy (The Brookings Institution, 4th Ed., 1983) at 141.

80/The Council of Economic Advisers has noted:

> Another important feature of the present tax system is the presence of a separate tax on corporate income. There is no necessary role for a separate corporate income tax in a pure income tax system. The income generated by corporations could be directly attributed to stockholders and taxed under the individual income tax system in the way partnership income is treated. The primary justification for a separate corporate tax is to ensure that retained corporate income is subject to tax. However, the corporate tax achieves this end only at the cost of introducing a number of distortions to economic behavior.
>
> Corporate earnings distributed as dividends are taxed more heavily than other forms of capital income be-

> cause they are first subject to the corporation income tax and then to the individual income tax. Earnings retained by the corporation may be overtaxed relative to noncorporate business income if the rate is greater than the shareholder's marginal individual income tax rate. Thus, the present tax system can impose a higher effective rate on activities carried out by corporations compared with activities performed outside of the corporate sector.
>
> Because interest payments are deductible while dividend payments to shareholders are not, the corporation income tax system provides an incentive to use debt rather than equity financing. This leads to more debt finance than the market would otherwise choose, increasing the vulnerability of corporations to bankruptcy. Because earnings paid out as dividends are taxed more heavily than earnings retained within the corporation, there is a tax incentive for corporations to retain earnings. This may lead to inefficient investment of retained earnings at rates of return lowe than those available to the shareholders.

Report of the Council of Economic Advisers (Feb. 1985) at 81.

81/Many commentators argue that because small businesses create many of the new jobs and much of the economic growth in the United States, it is particularly important not to create excessive tax barriers and costs for such businesses. See, e.g., Poffenbarger, "General Utilities Repealed: Why Small Business Should Be Excepted," 65 TAXES 604 (1987) and Shaw, "Impact Of Proposals On Acquistions Of Closely Held Corporations."

82/Zolt notes that the concepts of transactional consistency and asset consistency are both defensible. Transactional consistency addresses the issue of whether a purchaser should be allowed to accomplish with no potential tax liability something a seller could not have accomplished without recognizing a tax liability. Asset consistency addresses the issue of whether a purchaser, or multiple purchasers, should be required to assign the same type of basis, cost or carryover, to all assets acquired from the target corporation. The consistency rules under Sec. 338 generally require the election to be made on an affiliated group basis and are designed to preclude the acquiring corporation from selectively taking a stepped-up basis in some of the target's assets and a carryover basis in others. The Sec. 338 consistency rules have proven to be very complex in practice. See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 823-824.

83/See Faber, "Taxation of Corporations And Shareholders: Premises Of The Present System." Faber notes that for every premise, the 1954 Code contained at least five exceptions. See Id., at 5.

84/Receipts from the corporate income tax have become a much smaller percentage of total federal budget receipts in the 1970s and 1980s than they were in the 1950s and 1960s. Auerbach, for example, notes: "In recent years, the corporation income tax in the United States has accounted for less than 10 percent of federal budget receipts--a stark contrast to the 1950s and 1960s, when such taxes regularly contributed well over 20 percent of federal revenue." See Auerbach, "The Corporation Income Tax," in Pechman (ed.), The Promise of Tax Reform at 59-60.

In spite of significant reductions in yield of the corporation income tax and the distortive effects on business decisions and capital flows, few, if any, responsible commentators feel that the separate income tax on corporate taxable income will be repealed. See generally Ballentine, Equity, Efficiency, and the U.S. Corporation Income Tax (American Enterprise Institute for Public Policy Research, 1980).

Most commentators agree with Joseph Pechman's conclusion that in spite of the distortions and other problems associated with the imposition of a corporate income tax, a separate income tax on corporations is necessary to protect the integrity of the individual income tax system in the United States. See Pechman, Federal Tax Policy (1983) at 130.

85/See Faber, "Taxation of Corporations And Shareholders: Premises Of The Present System" at 10-12. Faber notes that the ability of many closely-held corporations to zero out their taxable income by paying out bonuses, making contributions to pension and profit-sharing plans, etc. often makes the imposition of full double tax much more theoretical than real for these corporations.

86/See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium" at 853 (noting that the tax law has always treated the sale of corporate stock as a shareholder level event and not as the sale of a portion of the underlying corporate assets and that the corporation's earnings and profits and other tax attributes are generally not relevant in determining the shareholder tax consequences of a sale of stock).

87/See Faber, "Taxation Of Corporations and Shareholders: Premises Of The Present System" at 12.

88/The acquisitions proposals implicitly accept Faber's assertions that the numerous fictions in the current provisions for tax-free reorganizations should be repealed and that Congress should accept the commercial reality that the typical acquisitive reorganization under Section 368 involves a sale of a business, rather than its readjustment or restructuring. See Faber, "Continuity of Interest And Business Enterprise: Is It Time To Bury Some Sacred Cows?" 34 Tax Law. 238 (1981) at 295.

Faber argues the most general fiction in the current law is that a tax-free reorganization involves a "rearrangement" or "restructuring" of a corporation as contemplated in the early reorganization statutes and judicial decisions. Faber thus rejects the proposition that forcing the acquiring corporation to use stock consideration to acquire a target corporation will ensure a "continuation" of the target. Faber thus questions the need for the statute, regulations and the judiciary to impose various tests to determine whether this "continuity" has in fact occurred at the corporate level (e.g., the continuity of business enterprise doctrine) and at the target shareholder level (e.g., the continuity of interest doctrine).

Faber states that the present continuity of business enterprise test "piles fiction upon fiction." Id., at 292-293. As noted, it is doubtful that the acquiring corporation continues the target corporation in any meaningful sense or that the former shareholders of the target corporation typically have a significant ownership interest in the acquiring corporation. Because the tax law has a deep respect for the separation of a corporation and its shareholders, a sale by the target corporation of its historic assets for cash would not result in a tax at the shareholder level absent a distribution of the proceeds. Thus, if the acquiring corporation is truly a continuation of the target, the fact that the acquiring corporation sells the entire business formerly conducted by the target or sells a significant part of the target's historic assets after an acquisitive transaction should not preclude tax-free reorganization treatment. Faber does not agree that post-transaction dispositions of the target's assets by the acquiring corporation is a valid or meaningful means of testing whether the acquisitive transaction was a restructuring or readjustment of the target corporation entitled to tax-free reorganization treatment. See Id. By repealing the continuity of interest and continuity of business enterprise requirements, the acquisition proposals implement Faber's suggestion that the fictions in the current law be removed.

89/See Faber, "Taxation Of Corporations and Shareholders: Premises Of The Present System" at 7. Faber notes it is often difficult or impossible to separate form and substance for tax-free reorganizations.

90/1982 ALI Study at 5. The ALI Study notes that the reason for the radical differences in treatment of stock and asset acquisitions is that:

> the realization rules are predicated on a deep respect for the concept of separate corporate identify. A stock acquisition, therefore, involves no realization of gain or loss by the acquired corporation, since there is no disposition of assets or receipt of consideration by the acquired corporate entity. Moreover, subject to special limitations on tax advantages, a stock acquisition involves preservation of basis for corporate assets and other tax attributes, as least as long as the acquired corporation is kept in existence, since these adhere to the acquired corporation itself without regard to the change in ownership of its stock. An asset acquisition, on the other hand, is treated as a simple purchase of assets by the acquiring corporation, with basis of corporate assets thereafter determined by cost in the acquisition transaction itself; neither basis nor any other tax attributes of the acquired corporation carryover in a nonreorganization acquisition.

Id., at 25.

91/Id., at 6.

92/See Levmore, "Recharacterizations And The Nature of Theory in Corporate Taxation," 136 U. Pa. Law Rev. 1019 (1988) at 1062. Levmore notes that the federal income tax law, particularly Subchapter C, is based almost exclusively on positive rather than normative theories. Levmore observes:

> Deferral and recognition are not neutral concepts in policy terms. One might, on the margin, prefer deferral rules because recognition rules discourage those things that will be counted as recognition

> events, but to permit deferrals is eventually either to forgive, which has its own efficiency costs, or to recognize gains built up over a longer period, which is then a treatment most profitably avoided.
>
> There is, in short, no normative theory or rule that suggests the optimal number or coverage of recognition rules. Given the decision to tax corporate gain and the decision to await recognition events, rather than to call for and tax periodic appraisals of changes in net worth, it is hard to argue passionately for or against any particular trigger, or recognition event. . . . On the other hand, allowing all intercorporate asset transfers to be nonrecognition events would give taxpayers too much freedom to determine when they wanted to recognize gain. While it is clear that someone must choose between these themes . . .it is doubtful that anyone has values or experiences from which to derive the optimal level of permissiveness.

Id., at 1062-1063.

93/See Faber, "Taxation of Corporations And Shareholders: Premises Of The Present System" at 7 and 13. Faber notes that the 1954 Code contained so many exceptions to the general nonrecognition rules contained in Sec. 336 (in-kind liquidating distributions) and in Sec. 337 (liquidating sales of appreciated assets), that it was not clear whether the general nonrecognition rule or the exceptions requiring corporate level recognition of the gain realized predominated. Taxpayer attempts to utilize the General Utilities doctrine and the Service's attempts to prevent abuse (as in the liquidation-reincorporation cases) were the central focus of tax planning for acquisitive transactions under Subchapter C of the 1954 Code.

94/The 1986 Code contains no mechanism by which the purchasing corporation can acquire the appreciated assets of a target, take a stepped-up basis in the assets, and also achieve a single target shareholder level tax as was possible under the complete liquidation and Sec. 338 transaction provisions of the 1954 Code. Bonovitz asserts that as a matter of sound corporate tax policy, Congress:

> should [provide] a statutory vehicle for taxpayers to treat an asset acquisition as not giving rise to gain recognition to the selling corporation, either treating it as a deemed stock acquisition or by requiring the carryover of basis to the purchaser as a trade-off for nonrecognition treatment to the corporate

seller.

Bonovitz, "Impact Of The TRA Repeal of General Utilities" at 395.

After the enactment of the TRA of 1986, Zolt urged Congress to decide whether:

> a corporation should recognize gain on the transfer of assets out of the [economic] group in instances where the assets remain in corporate form and retain their historic bases.

Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 820.

95/See, e.g., the testimony of the AICPA on the final acquisition proposals. In arguing against repealing the General Utilities doctrine primarily to resolve the alleged lack of symmetry which occurred under the 1954 Code (i.e., the acquiring corporation could take a fair market value basis for the target's assets without the target recognizing of all gain realized on the liquidating sale or distribution of its appreciated assets), the AICPA stated:

> These items [acquiring corporation basis and target corporation recognition of gain] are simply not comparable; their relationship is of no relevance to the proprietary of General Utilities. Inside basis (and thus the amount of step-up [to the acquiring corporation]) will reflect the accumulated profits (or deficits) of the target corporation whereas a shareholder's basis in the stock will be unaffected by corporate earnings. Except in the case of S corporations, there can be no symmetry between shareholder gain and basis step-up [to the acquiring corporation]. In fact, the amount of shareholder gain recognized over time on stock of a commercially successful corporation will generally exceed any inside basis step-up as a result of deemed or actual asset purchases.
>
> For many years, the only 'symmetry' required for a corporate level step-up in basis has been symmetry of tax treatment at the [target] shareholder and [acquiring] corporate levels. The policy behind this rule is that basis step-up should only occur in a taxable transaction. Congress has long supported a policy that in certain sales and liquidations only one level of tax should imposed at the [target]

> shareholder level. The fact that the 'price' paid for this basis step-up is inadequate or overly generous to the Government has never been relevant.

1985 Hearings on Reform of Corporate Taxation at 329-330.

96/Sec. 361(b)(1) of the 1986 Code provides a general rule that Sec. 336 (which generally requires the corporate level recognition of gain when an appreciated asset is distributed on an in-kind basis to the shareholders or is sold in a complete liquidation) is not applicable to either a corporate liquidation which is part of a tax-free reorganization or a corporate distribution of property to the extent that the recipient does not recognize gain under Secs. 351 through 368. This issue, and related tax planning issues are discussed in Brandt and Maloney, "Reorganization instead of liquidation may accomplish same result with much less tax," 39 Tax'n for Acct. 388 (1987).

97/Most commentators believe the repeal of the 1954 Code nonrecognition provisions which codified the General Utilities doctrine was a necessary but not a sufficient condition for the enactment of the acquisition proposals, particularly the explicit electivity of corporate level tax treatment. The Treasury Department expressly conditioned its support for the acquisition proposals on the repeal of General Utilities. See 1983 Hearings on Reform of Corporate Taxation at 9.

98/1982 ALI Study at 12.

99/The 1982 ALI Study states:

> Dividends constitute a realization of income for shareholders but generally have no effect on the computation of corporate taxable income. Shareholders may realize gain by a sale of shares even when the underlying appreciation in value remains unrealized at the corporate level. . . . It is assumed in these proposals that separate computation of corporate and shareholder taxable income will generally continue.
>
> Notwithstanding the general separation of computation of taxable income, there are various possible connections between the treatment of corporate and shareholder issues in acquisition transactions. For one thing, transactions are classified under existing law in ways that control their tax treatment at both corporate and shareholder levels. Qualification as a reorganization, for example, has drastic implications for the computation of both corporate and shareholder

taxable income.

> It is not assumed or proposed that this kind of connection be maintained. Indeed, one of the basic proposals in this report is to eliminate the categorical distinction between reorganizations and other acquisitions and to substitute a more functional classification into cost-basis and carryover basis acquisitions, which would have only to do, primarily, with the way in which potential tax liabilities at the corporate level are dealt with . . . . Shareholder issues are then to be dealt with separately from corporate issues except when some specific reason exists for making a connection.
>
> There is another less explicit sort of connection in existing law, which is a kind of assumption that a particular treatment at the corporate level depends on a particular kind of treatment at the shareholder level or vice versa. For example, corporations are allowed to escape tax on the sale or distribution of appreciated property in the course of a complete liquidation. While this provision had its origin in the conceptual notion that no gain or loss is realized on a distribution in kind, its continuation and extension apparently rest partly on a judgment that the payment of taxes by the shareholders is enough of a tax on the underlying appreciation in these circumstances. The validity of this sort of connection has not been assumed in formulating these proposals.

See 1982 ALI Study at 12-13.

100/See Willens, "The Significance of Form: Some Subchapter C Manifestations," 12 J. Corp. Tax'n 72 (1985).

101/See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution" at 417.

102/Many commentators have criticized the assumption in the ALI Studies and the acquisition proposals that the potential and conditional tax liabilities of the target corporation can most efficiently be handled by directly linking the issues of cost or carryover basis for the target's assets in the hands of the acquiring corporation and whether the target corporation recognizes the gain inherent in its assets. Zolt notes that allowing the acquiring corporation to elect cost basis treatment (in which the target corporation recognizes the appreciation in its assets and pays the appropriate "toll" tax) or carryover basis treatment (in which the target corporation does not recognize gain and pays no toll tax) are simply not equivalent propositions on a present value basis. Zolt states:

> The potential for future additional corporate-level tax is simply not the economic equivalent of a current tax on the appreciation at the time of disposition.

Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 827.

103/Yin has so characterized the acquisition proposals. See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution."

104/See generally Unger, "Gain Recognition and Basis in Acquisitions." A major source of economic inefficiency under the 1986 Code is that the carryover basis acquisition often desired by the target corporation and its shareholders may be unacceptable to the acquiring corporation for legal (e.g., assumption of target liabilities) or other reasons.

105/Unless a Sec. 338 election is made, the sale of corporate stock is not treated as the sale of a proportionate share of the underlying corporate assets under the 1986 Code. Thus the sale of corporate stock is not normally a recognition event at the corporate level. Because the tax basis of the corporation's assets is not changed, the sale and purchase of corporate stock is a carryover basis transaction.

106/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 822.

107/See Id.

108/Zolt states:

> The strong form position focuses on the corporation as a taxpayer and seeks to tax the corporation on any built-in appreciation inherent in the transferred assets. Absent clear Congressional grace, it views the transfer from one corporation as an appropriate time to impose a tax on corporate-level gain and finds no good policy reason for nonrecognition treatment. The strong form position rejects the ALI proposals that allow taxpayers to effectively choose between (i) stepped-up basis and immediate corporate-level tax and (ii) carryover basis and no cor-

> porate level tax, as an unequal trade-off that fails to recognize the time value of money.
>
> The strong form has variations. At one extreme, the strong form requires gain to be recognized at the corporate level whenever stock is transferred. This has the effect of requiring a Section 338 election in connection with stock transfers. A less extreme version requires gain to be recognized on all assets transferred in liquidation, whether or not the assets leave the economic group.

Id., at 822-823.

109/See Id. The acquisition proposals follow the weak form of taxation. The TRA of 1986 adopted the weak form of taxation in order to deal with the lack of symmetry between acquiring corporation basis in the target's assets and whether the target should recognize gain or loss in an acquisitive transaction.

110/See Faber, "Taxation Of Corporations And Shareholders" Premises Of The Present System" at 14.

111/Brannon notes that many of the current problems with the 1986 Code are caused by deviations from a comprehensive definition of income, allowing all types of tax expenditures, and the legalistic notion that gains must be "realized" in order to be "recognized." See generally Brannon, "Tax Loopholes As Original Sin: Lessons From Tax History". Brannon concludes that many of the fundamental problems in the federal income tax system were born in the "original sin" of sloppy thinking and have resisted baptism. See Id., at 1763. Brannon states a primary lesson of income tax experience in the United States is the lack of opportunity to construct detailed tax rules wisely and then only when the tax law is being introduced:

> The method by which substantive statutory law is developed is a chaotic political process which is rarely scientific. The critical background work had not been done, staff support was negligible and the political payoff was in 'getting' the moneyed east, not in conceptual elegance.

Id., at 1765.

112/The 1982 ALI Study at 10 states:

> To a considerable extent, these [acquisition] proposals represent a restatement of existing law along

more functional and coherent lines. The greatly simplified categorization of acquisition transactions that is proposed, and its elective character, are implicit in the existing rules, and the main effect of the proposals is just to bring these characteristics out in the open.

113/1977 ALI Study at 3. The 1982 ALI Study at 1 also indicates that one fundamental set of issues addressed by the acquisition proposals is what to do about such previously untaxed gains and losses at both the corporation and shareholder levels.

114/Id.

115/McClure, "Where Tax Reform Went Astray" at 1630-1631.

116/1982 ALI Study at 1.

117/Id., at 2.

118/Id., at 6.

119/Id., at 6-7.

120/See Faber, "Taxation Of Corporations And Shareholders: Premises Of The Present System" at 14-15.

121/Tax Aspects of Mergers and Acquisitions at 11-12. If, for example, a shareholder of a potential target corporation holds highly appreciated stock but an acquisitive transaction cannot be structured as a carryover basis transaction (e.g., due to legal issues such as the acquiring corporation not wanting to become responsible for the liabilities of the target), the tax law may operate as a disincentive to the consummation of an otherwise desirable acquisitive transaction.

122/Id., at 13-14.

123/1982 ALI Study at 24. The 1982 ALI Study also states:

> The classification of acquisition transactions under existing law is a product of the peculiar way our law has evolved. Part of that evolution has been a conceptual elaboration by the courts and the Internal Revenue Service of what constitutes a taxable realization of gain or loss in the absence of any specific statutory provision governing the matter. This elaboration initially had constitution implications and the Congress has refrained from participation in

> it, responding instead by specifying that in certain categories of transaction gain or loss, even though realized, is not to be recognized. The main such category is reorganizations, which are governed rather systematically by a separate set of statutory nonrecognition and basis provisions.

Id.

> The first question, therefore, in classifying an acquisition under existing law is whether it qualifies as a reorganization. That is determined by reference to a very complicated statutory definition together with an extensive body of judicial and administrative exegesis. Most forms of acquisitions--mergers, consolidations, stock acquisitions, asset acquisitions, carried out directly or by use of a subsidiary--may qualify for reorganization treatment, though the requirements for reorganization status differ markedly for different forms of transactions.

Id., at 24. The 1982 ALI Study also states that the operative provisions of the tax-free reorganization provisions have the effect of minimizing the tax effects of differences in the legal form of the transaction and corporate procedures. See Id., at 25.

> But if an acquisition is not a reorganization, then it will have very different tax consequences if it is a stock acquisition than if it is an asset acquisition. The realization rules are predicated on a deep respect for the concept of separate corporate identity. A stock acquisition, therefore, involves no realization of gain or loss by the acquired corporation, since there is no disposition of assets or receipt of consideration by the acquired corporate entity. Moreover, subject to certain special limitations on tax advantages, a stock acquisition involves preservation of basis for corporate assets and other tax attributes, at least as long as the acquired corporation is kept in existence, since these adhere to the acquired corporate entity itself without regard to the change in ownership of its stock.

Id., at 25.

> An asset acquisition, on the other hand, is treated as a simple purchase of assets by the acquiring corporation, with basis of corporate assets thereafter determined by cost in the acquisition transaction it-

> self; neither basis nor other tax attributes of the acquired corporation carryover in a nonreorganization asset acquisition. The transferor may well realize gain or loss, though that is a complicated matter. Gain or loss is realized if the transferor corporation sells its assets to the acquiring corporation, even though the consideration for the sale may be paid directly to the transferor corporation's shareholders. On the other hand, a distribution of assets by the transferor to its shareholders has been considered not to involve any realization of gain or loss by the distributing corporation even if the distribution is for the purpose of enabling the shareholders thereafter to sell the assets to an unrelated acquiring party.

Id., at 25-26.

> These results, however, are subject to a number of exceptions and modifications, statutory and nonstatutory, so that it is difficult to generalize accurately about the taxation of transferors in nonreorganization asset transfers. Whatever is to be done about potential corporate tax liabilities for previously unrealized gains and profits of the acquired business, however, is done by taxing the transferor or its distributees in connection with the acquisition transaction, not by taxing the transferee in connection with its subsequent conduct of the acquired business.

Id., at 26. As discussed in Chapters III and IV of this Study, one of the goals of the Act is to create a direct trade-off between the disposition of the conditional and potential tax liabilities of the target and whether the acquiring corporation takes a cost or carryover basis for the target's assets. This is done in Proposal Three (explicit electivity of corporate level tax results) and Proposal Four (partially uncoupling the corporate and shareholder/security holder level tax consequences of a qualified acquisition).

124/See Faber, "Taxation Of Corporations And Shareholders: Premises of the Present System" at 15. Under current law for tax-free acquisitive reorganizations, (1) the continuity of interest doctrine implements the principle that the shareholders of the target corporation must receive an ownership interest in the acquiring corporation and (2) the continuity of business enterprise doctrine implements the principle that the acquiring corporation must continue to operate the target's business(es) or use the target's assets in a business in order to obtain tax-free treatment. Current law for tax-free acquisitive reorganizations requires that a transaction satisfy the definitional provisions of Sec. 368(a)(1) and the judicial doctrines at the corporate level in order for the transaction to be taxed as a "reorganization." If the transaction is a not a reorganization, tax-free treatment at the shareholder and security holder level is not available even if the shareholders only receive stock of the acquiring corporation. Detailed discussions of the statutory and judicial conceptions of transactions constituting "tax-free reorganizations" are contained in Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1340-1390 and Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Proposals."

125/See Id.

126/Lobenhofer states:

> The real determination that Congress must make is whether corporate managers should be able to rearrange the assets of acquired businesses, recognizing gain and stepping up basis of only the assets that the manager selects or whether the assets of a whole business or group of businesses must be treated consistently. This in turn hinges on Congress's view of mergers and acquisitions.

Lobenhofer, "The Repeal of General Utilities for Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform" at 184.

127/As discussed in Chapter III of this Study, the definitions of qualified acquisitions are based on the present tax-free reorganization definitions and administrative pronouncements for the basic "A," "B," and "C" reorganizations and the triangular variations. The ALI proposals seek to achieve a pre-1934 definition of a tax-free reorganization without the judicially imposed doctrines which now serve as prerequisites for tax-free reorganization treatment. See 1982 ALI Study at 165.

128/See 1977 ALI Study at 5-6.

129/See 1982 ALI Study at 10.

130/The ALI believes that unless there is an overriding and very specific reason to link the corporate and shareholder level tax consequences, as is presently done for tax-free reorganizations, the taxation of the shareholders and security holders of the target corporation should be a separate matter from how the corporate parties elect to be taxed. See 1977 ALI Study at 6.

131/See 1982 ALI Study at 9.

132/See Id., at 28.

133/See Id., at 6 and 165.

134/See Id., at 182.

135/See Id., at 167.

136/See 1977 ALI Study at 2.

137/1982 ALI Study at 4.

138/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 832. Zolt also asserts:

> Congress failed in the 1986 Act to delineate clearly the scope of the repeal of the General Utilities doctrine. It is unclear whether circumstances exist in which a corporation can avoid the recognition of gain on the transfer of appreciated property. The question often arises when an acquiring corporation seeks to dispose of unwanted appreciated assets following an acquisition.

Id.

139/See, e.g., Block, "Liquidations Before and After Repeal of General Utilities," 21 Harv. J. of Legis. 307 (1984); Shube, "Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities," 12 J. Corp. Tax'n 3 (1985); and Wolfman, "The Case for Repeal of the General Utilities Doctrine," 22 San Diego L. Rev. 81 (1985). Not all commentators agreed that the perceived problems in the federal income taxation of corporations and their shareholders justified the repeal of the General Utilities doctrine. See, e.g., Beck, "Distributions in Kind in Corporate Liquidations: A Defense of General Utilities," 38 Tax Law. 663 (1985) and Blum, "Behind the General Utilities Doctrine, Or Why Does the General Have So Much Support from the Troops?" 62 TAXES 292 (1984).

140/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 820.

141/See generally Poffenbarger, "General Utilities Repealed: Why Small Business Should Be Excepted." Poffenbarger argues that Congress should provide some form of permanent relief to shareholders of small corporations to mitigate the double tax effects of the repeal of General Utilities. In testimony before Congress in 1983, Nolan argued that the repeal of the General Utilities doctrine would have a disproportionate and very negative affect on privately held corporations. Nolan stated: "The impact will be almost entirely on closely held family businesses; large, publicly-held companies seldom undergo complete liquidation. This is neither an efficient or a fair tax increase, and I recommend strongly against it." See 1983 Hearings on Reform on Corporate Taxation at 148. Nolan also argued that repealing General Utilities would require family corporations to pay a double tax (a combined tax at up to 42.4 percent at the maximum current corporate and individual long-term capital gain rates) upon a complete liquidation of retained earnings reinvested in the business which is in direct contradiction to 50 years of the operation of the tax system. Nolan also stated that repealing General Utilities will create an undesirable bias in the tax law which will encourage family corporations to merge tax-free into publicly-held corporations. Such mergers will interfere with the demonstrated job creating potential of family businesses and interfere with the allocation of capital to family corporations. See Id.

142/Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 820.

143/See Id., at 822.

144/See generally Kotlarsky, "Stepping Up Basis: Purchase Of Stock Or Purchase Of Assets."

145/Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process" at 46. As discussed in Chapter III of this Study, many commentators felt that the doctrine may have been responsible for both distributive and churning mergers.

146/See Id., at 40. See also Segal and Konselman, "Liquidation-reincorporation: issues and planning in the battle over recharacterization," 18 Tax Adviser 337 (1987).

147/The Joint Committee on Taxation, as well as many other commentators, states that the repeal of the General Utilities doctrine would, in and of itself, do much to reduce the use of mergers as devices for distributing corporate income and transferring tax benefits. See Tax Aspects of Mergers and Acquisitions at 15. The Joint Committee on Taxation has observed:

> Perhaps [the] most significant proposals 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.

Id., at 57.

148/See 1982 ALI Study at 8.

149/See 1985 Hearings on Reform of Corporate Taxtion at 324-325.

150/See, e.g., the lack of position taken by the Tax Section of the American Bar Association on the final acquisition proposals in 1985. Hugh Calkins, Chairman of the Tax Section, refused to comment on the acquisition proposals because the ABA had not had an opportunity to take an official position. See 1985 Hearings on Reform of Corporate Taxation at 174. Leduc and Gordon suggest that this "paralysis" of the ABA was illustrative of a lack of a constituency of support for the acquisition proposals and does much to explain why they were not enacted in either the TRA of 1986 or the Revenue Act of 1987. See Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future" at 37-152.

151/Roche, Myers and Zucker, for example, have observed:

> . . . as a practical matter, the repeal of the General Utilities doctrine (as codified in Sections 336 and 337 of the 1954 Code) is likely to result in fewer transactions in which an asset basis step-up will be sought. Transactions which were protected by old Section 337 and which resulted in basis step-up to the buyer and little or no tax to the selling corporation will generally be subject to tax both at the corporate level and the shareholder level. . . . this type of transaction will be used less than in the past or that diversion of consideration from the corporate level to the shareholder level will be emphasized.
>
> . . . qualified stock purchases with elections under Section 338 are less likely to be utilized. Again,

the repeal of the General Utilities doctrine will generally require full gain recognition by the target corporation, with the tax borne, in most cases, by the purchasing corporation. Frequently, the present value of this tax will exceed the present value of the future tax savings resulting from the basis step-up. Certainly, purchasers will have to analyze these costs and benefits very carefully before deciding whether or not to make the step-up election under Section 338.

One likely result of these changes is that tax-free reorganizations may be more desirable than taxable transactions. From the standpoint of the seller, they will eliminate an immediate tax at both the corporate and shareholder levels. Also, they will be attractive to the buyer since the seller's imputed tax savings presumably will be reflected in a reduced purchase price. Finally, such transactions will avoid the types of controversies that are likely to arise under Section 1060.

Roche, Myers and Zucker, "Price Allocation on Acquisitions and Basis Step-Up: Tilting at Windmills?" 65 TAXES 833 (1987) at 843. Section 1060, added to the Code by the TRA of 1986, conforms the basis allocation rules for taxable asset acquisitions and Sec. 338 transactions. The technical provisions and related tax planning issues are discussed in Abrams and Cinnamon, "Purchase price allocation restricted by Tax Reform Act of 1986," 38 Tax'n for Acct. 40 (1987); Garland, "The Impact of New Sec. 1060 on Purchase Price Allocations," 18 Tax Adviser 793 (1987); and Swirsky, "Purchase Price Allocations in Taxable Asset Acquisitions," 67 TAXES 252 (1989).

152/See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution."

153/See 1983 Hearings on Reform of Corporate Taxation at 18-19. The Treasury Department admitted that under the 1954 Code, the law for acquisitive transactions is effectively elective for well-advised taxpayers.

154/See, e.g., Arthur Andersen & Co., Washington Tax Letter "Gremlims Hidden in 1988 Tax Returns Likely to Rekindle Tax Reform Debate (No. 88-2, March 1988).

155/Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution" at 417. Yin's statement has been criticized because it ignores the resulting differences in basis of target's assets and stock in the hands of the acquirer. In the asset acquisition, the target's assets will take a stepped-up basis in the hands of either the acquiring corporation or its shareholders upon an in-kind complete liquidation. In the tax-free liquidation of the target into its new parent without a section 338 election, the parent will take a carryover basis in the target assets. Yin's description of a double tax on the asset acquisition assumes that all assets acquisitions are followed by a liquidation of the target. Yin's description of a single tax on the stock acquisition ignores the resulting tax to the acquiring corporation if the appreciated assets transferred from the target are sold. Thus Yin's description implies a starker distinction in the long-run consequences of these alternative acquisition methods than may exist. See Cummings, "More On the Yin-Shores Debate Over Carryover Basis Asset Acquisitions," 38 Tax Notes 293 (January 18, 1988).

156/The operation of Section 334(b)(2) is described in Pugh, "Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and Substance," 35 Tax L. Rev. 359 (1980).

157/See H.R. No. 1337, 83rd Cong., 2d Sess. (1954), reprinted in 1954 U.S. Code Cong. & Adm. News at 4063-4064 and S. Rep. No. 1622, 83rd Cong., 2nd Sess. (1954), reprinted in 1954 U.S. Code Cong. & Adm. News at 4679-4680.

158/See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution" at 417. Section 634 of the TRA of 1986 requires the Treasury Department to study Subchapter C problems and to submit a report to the appropriate Congressional committees by January 1, 1988. The status of this report will be discussed in Chapter V of this Study.

159/Id., at 418.

160/Yin states:

> One of the reasons for the uncertainty and lack of consensus is the absence of a unifying theory for implementation of the carryover basis proposal. 'Carryover basis' gradually has come to mean all things to all people: a method of curing all of the multitude of ills in Subchapter C. Some believe that it provides the means to equalize the tax treatment of corporate business organized with divisions as opposed to subsidiaries. . . . Still others view it as an answer to the need for relief from the re-

peal of the General Utilities doctrine.

Id., at 415.

161/Id.

162/Id.

163/See Id.

164/See Id., at 420. Yin describes the implementation factors as follows:

> In general, the design of an elective carryover basis approach raises four fundamental questions. First, what type of asset acquisition will qualify for the elective treatment? Does there have to be a transfer of all or substantially all of the target assets, or will a transfer of some lesser portion suffice? Second, does the acquisition have to involve a single corporate buyer, or could a sale of assets to multiple buyers qualify for the election? Third, does the target corporation whose assets are acquired have to liquidate as part of the transaction, or will a distribution to the target's shareholders of an amount equal to the sale proceeds be adequate? Lastly, what type of consistency requirement, if any, should be imposed in the transaction? For example, assuming there is a qualifying asset acquisition that permits the parties to elect 'cost' or 'carryover' treatment with respect to the acquired assets, to what extent must any such election be consistently made for all assets acquired with a contemporaneous period of the qualifying asset acquisition?

Id.

165/Id., at 419. Most commentators agree that Congress will also consider these factors, particularly revenue, in deciding whether to enact the four acquisition proposals.

166/Joint Economic Committee Study at 1-3.

167/See, e.g., The Fair Tax (H.R. 3271, S. 1421) proposed by Senator Bill Bradley and Congressman Richard Gephardt and The Fair and Simple (FAST) Tax (H.R. 6165, S. 2948) proposed by Congressman Jack Kemp and Senator Robert Kasten. These proposals advocate a broadened tax base and reductions in marginal tax rates and are similar to the comprehensive tax reform proposals issued by the Treasury Department in 1984. See Treasury I (Vol. 1) at 169-190.

168/Many advocates of comprehensive tax reform agree with the following statement made by President Reagan in 1985:

> Personal tax rates should be reduced further to encourage stronger economic growth which, itself, is our best tool for putting deficits on a steady downward path. Our tax system needs basic reform. It is extraordinarily complicated; it leads to substantial economic inefficiency; and it is widely believed to be unfair.

Economic Report of the President (Feb. 1985) at 8.

169/See 1985 Comprehensive Tax Reform Proposals at 8.

170/See "World Trends in Tax Policy: New Urgency After the Fall," Price Waterhouse International Tax Rev. (Nov./Dec. 1987). Price Waterhouse asserts that the reductions in marginal tax rates enacted by the TRA of 1986 has caused other countries to lower their marginal tax rates so that their "best and brightest" citizens will not emigrate to the United States. Price Waterhouse observes that the United Kingdom is the leading advocate of lowering corporate tax rates and that many industrial nations are studying whether their corporate and individual tax systems should be formally integrated.

171/See, e.g., Frumer, "Just What Does the 1986 Tax Reform Act Reform?" 30 Bus. Horizons 3 (1987). Frumer states that virtually every tax bill enacted since 1913 has been justified as "tax simplification" or "tax reform." See Id., at 3. Frumer equates reductions in effective tax rates with tax reform and ease in making tax computations with tax simplification. See Id., at 7-10.

172/See Sprague, "More Battles Over Tax Burdens" Federal Tax Policy Memo (May/June 1987). Sprague notes that the basic 28 percent top marginal tax rate for individual taxpayers in the 1986 Code is "politically unstable" and that Congress will face continual testing of its sentiment not to reimpose higher marginal tax rates in the future. See Id., at 1. Sprague also believes any attempt to broaden the individual tax base of the 1986 Code will be very difficult to achieve. See Id.

Sprague states that supply side economists stress the need to reduce marginal tax rates to increase work and saving incentives while "tax reformers" stress the need for lower marginal tax rates in order to discourage tax shelter arrangements. See Id., at 3. Sprague states:

> Supply-siders argue that high [tax] rates are simply counterproductive. Many tax reformers are troubled by the implications of high marginal rates as an invitation to special treatment, complexity, and noncompliance.

Id., at 4.

173/See Gephardt and Wessel, "Tax Reform" A 'But-For' Test," 29 St. Louis U. L. J. 895 (1985) and Sparks, "The Bradley-Gephardt Fair Tax Plan; Is It Fair to Corporations and Individual Shareholders?' 29 St. Louis U. L. J. 125 (1985).

174/In commenting on the lack of success of lobbyists in attempting to influence members of Congress on specific aspects of the TRA of 1986, Yin states:

> As we were all reminded recently in Showdown at Gucci Gulch, the 1986 Act is littered with the disregarded pleas of witnesses and lobbyists alike. The opposition of business groups and professional trade organizations, alone, is unlikely to carry the day.

Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution" at 419.

Tax reform efforts involve a host of random events and political trade-offs which often seem to have little, if anything, to do with theories of taxation, implementing specific policies, or similar conceptual concerns. An interesting discussion of the rather haphazard and seemingly irrational manner in which the TRA of 1986 was eventually enacted by Congress is contained in Birnbaum and Murray, Showdown At Gucci Gulch (Random House, 1987).

See generally Doernberg, "The Market For Tax Reform: Public Pain For Private Gain," 41 Tax Notes 965 (November 29, 1988); Verdier, "A Framework For Predicting Congressional Action," 41 Tax Notes 435 (October 24, 1988); and Nacev, "The Elitist Nature Of Tax Policymaking," 42 Tax Notes 1141 (February 27, 1989).

175/McClure, "Where Tax Reform Went Astray" at 1635.

176/Id., at 1645.

177/In commenting on the Preliminary Staff Proposals, DeArment, the Chief of Staff for Senator Robert Dole, characterized the Subchapter C Revision Act as a simplification proposal which will probably lose revenue due to the effective expansion of the types of acquisitive transactions which can obtain tax-free treatment at both the target corporation and target shareholder and security holder levels. DeArment asserts that simplification efforts are motivated by much different concerns that cause most major tax legislation to move through Congress. See DeArment, "Introductory Remarks On The Senate Finance Committee Staff's Report On Subchapter C, The Subchapter C Revision Act of 1985," 5 Va. Tax Rev. 595 (1986) at 595-596.

178/Business and other groups attempted to prevent the repeal of General Utilities in the TRA of 1986. See, e.g., "Lobbyists Rally to Kill Proposals in Tax Overhaul That Could Undercut Many Corporate Takeovers," Wall St. J. (July 28, 1986) at 58.

179/Jacobs notes the most likely means of achieving true tax simplification is to propose small packages (such as the Installment Sales Revision Act of 1980 and Subchapter S Revision Act of 1982) which have the unanimous support of the organized tax bar, the AICPA, the Treasury Department, the Staff of the Joint Committee on Taxation, and the tax community at large. Large tax reform packages, such as the Subchapter C Revision Act, are much less likely to have unanimous support and are therefore more difficult to enact. See Jacobs, "Reorganizing the Reorganization Provisions" at 415-416.

Other problems in enacting tax simplification and tax reform occur because those who formulate and enact the tax laws are often insulated from taxpayers and their advisers, from the administrative agencies, and from the judiciary. Roberts, for example, states:

> This [insulation] is in part because Congress, many of the Treasury staff and their academic advisers are substantially insulated from observation of the law in practice; in part because they distrust the conclusions expressed by practitioners; and in part because of inadequate manpower; the difficulty of learning from the experience of others and the difficulty of convincing anyone that a path he has been following for many years is in the wrong direction.

Roberts, "Simplification Symposium Overview: The Viewpoint of the Tax Lawyer," 34 Tax L. Rev. 5 (1978) at 9.

180/See, e.g., 1985 Hearings on Reform of Corporate Taxation at 335. The AICPA joined a number of other commentators in urging Congress not to deal with the acquisition proposals at the same time Congress was considering other major tax reform proposals for corporate-shareholder taxation and individual taxation including the possible repeal of General Utilities and the elimination of lower tax rates for long-term capital gains. In testifying on the final acquisition proposals in 1985, a representative of Tax Executives Institute (TEI) urged Congress to address the question of how the acquisition proposals fit into the overall comprehensive tax reform effort before evaluating them. The TEI representative also asserted that if Subchapter C reform was to be separated from comprehensive tax reform, Subchapter C reform should follow the enactment of comprehensive tax reform. See 1985 Hearings on Corporate Tax Reform at 513.

181/Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance and Process" at 31.

182/See DeArment, "Introductory Remarks On The Senate Finance Committee Staff's Final Report on Subchapter C, The Subchapter C Revision Act of 1985" at 595-596.

183/See Id., at 597.

184/See Id. DeArment notes that tax simplification legislation is a "good-government effort" in which the staff of the Congressional tax writing committees and the committee chairman make a sincere effort to improve the tax law.

185/DeArment states:

> . . . simplification by itself carries no real clout. To the extent simplification generates some controversy, as this [Subchapter C] project does, there may even be some political disadvantages from the standpoint of a member because members don't like to have anybody mad at them. So in short, simplification, and the Subchapter C project in specific, is a very fragile process that operates more or less on a consensus basis and the constituency is largely the constituency that is represented in this room; it is the organized bar associations and groups, and to some extent the accountants and academics.
>
> This project, like all the other simplification projects, really is in the hands of those in this room to either promote or kill so we can put this project back on the shelf like the ALI and others. As I look

> ahead to the future of this project, I don't think the future as one coherent piece is necessarily clear or particularly bright. The Treasury's reaction to this project in their latest testimony I think is fairly instructive. In 1983, Treasury was generally positive in their testimony, saying that they wanted to reserve specific endorsement until they had a chance to look at specific legislative language. We, in the final report [the Subchapter C Revision Act of 1985], published the specific legislative language and then we had a hearing on the final report just last month [September 1985] and Assistant Secretary Pearlman testified that the Subchapter C project should wait until tax reform is disposed of.

Id., at 595-596.

186/See Lobenhofter, "The Repeal of General Utilities For Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform" (asserting that by repealing General Utilities without making the other changes proposed by the Subchapter C Revision Act, the TRA of 1986 is incomplete tax reform for corporate-shareholder transactions). See also Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium." Zolt asserts that although many of the changes made by the TRA of 1986 and the Revenue Act of 1987 were not desirable based on any of the traditional criteria for evaluating tax law changes, the changes enacted fundamentally altered the corporate tax system. See Id., at 839. Zolt states:

> Apart from revenue considerations, Congress did not give much consideration to these fundamental changes and, as a result, many of their consequences were not intended.

Id.

187/See Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium" at 868-869. Zolt asserts that taxation as an S corporation achieves almost complete integration of the corporate and individual tax systems for eligible corporations. Zolt notes that the 1986 Code will cause shareholders of ineligible corporations (particularly publicly-held corporations) to devise means by which money and assets can be withdrawn from the corporation in a deductible manner (e.g., shareholders will lease assets to the corporation and corporations will substitute debt for equity in their capital structures).

188/See Id., at 840, 848, 854. Zolt asserts that by upsetting the rough equilibrium between corporate and individual tax systems which existed under the 1965 Code, the TRA of 1986 and the Revenue Act of 1987 will strongly influence taxpayer decisions regarding the form in which to operate a profit-seeking business, financing strategies, and dividend policies. Zolt notes that if the corporate and individual tax systems are in rough equilibrium, the tax law as a whole is more neutral and taxpayers are less likely to alter their behavior solely for tax reasons. Zolt concludes that in pre-TRA 1986 tax legislation, Congress chose not to directly address the biases created by the imposition of a separate, unintegrated corporate income tax but instead hoped that the compensating biases in the corporate and individual income tax systems would "keep things balanced."

189/See Id., at 868-869.

190/See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquistions and Dispositions: Substance and Process: at 17.

191/In commenting on comprehensive tax reform efforts, Lobenhofer states:

> Any proponent of tax reform assumes that many of the features of the current law will remain unchanged after the reformed provisions have been enacted. The proponent of a tax change may believe that a present rule is desirable and should not be changed, or the proponent may believe that a less than perfect provision will not be changed for political or administrative reasons.

Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform" at 165. An example of a limited tax reform proposal for partnership taxation is contained in Erickson, "An Appeal for Repeal of Section 751," 65 TAXES 365 (1987).

192/See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquistions and Dispositions: Substance and Process: at 75-76.

193/1985 Hearings on Reform of Corporate Taxation at 335.

194/See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance and Process at 64.

195/See Id., at 64-65.

196/See Id.

197/See generally 1984 Comprehensive Tax Reform Proposals at 2-6 and 1985 Comprehensive Tax Reform Proposals at 3-7.

198/See, e.g., Miller, "Federal Excise Taxes: Approaching Deficit Reduction from the Revenue Side," 74 Econ. Rev. 21 (March 1989) at 26. In discussing whether narrow-based consumption taxes (e.g., federal excise taxes on alcohol, tobacco, and motor fuels) meet the generally accepted objectives of a good tax structure, Miller asserts that such excise taxes should be evaluated by the generally accepted objectives of equity, economic efficiency, and simplicity. Miller states that a good tax system should be simple, understandable by taxpayers, as free as possible from arbirtary administration, and have low administrative and compliance costs. See Id., at 30.

199/The economic, public finance, and tax literature contains overwhelming support for using these four general objectives of taxation as the general criteria to evaluate efforts at comprehensive tax reform in the acquisitive transactions area of the tax law. Adam Smith (1732-1790), a famous political economist, stated four maxims or canons of taxation in his book, An Inquiry into the Nature and Causes of the Wealth of Nations. Smith's four maxims of taxation are: (1) taxes should be equal or equitable; (2) taxes should be based on the taxpayer's ability to pay; (3) taxes should be certain; and (4) taxes should be convenient to pay. Smith's four maxims of taxation are quite similar to the major goals of comprehensive tax reform efforts in the United States. An interesting discussion of the work of Adam Smith, John Stuart Mill, E.R.A. Seligman, and other individuals influential in the public finance and tax areas of inquiry in the United States, is contained in H. Groves, Tax Philosophers (University of Wisconsin Press, 1974).

200/See Miller, "Federal Excise Taxes: Approaching Deficit Reduction from the Revenue Side" at 27.

201/Id.

202/1983 Hearings on Corporate Tax Reform at 140.

203/1985 Comprehensive Tax Reform Proposals at 3.

204/McClure, "Where Tax Reform Went Astray" at 1622.

205/See, e.g., Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative."

206/McClure, "Where Tax Reform Went Astray" at 1623 and 1985 Comprehensive Tax Reform Proposals at 17.

207/See 1985 Comprehensive Tax Reform Proposals at 3.

208/Some commentators assert that minimizing deviations from the existing tax system is the appropriate benchmark for evaluating proposed changes in the tax law. See Yin, "A Carryover Basis Asset Acquisition Regime?: Few Works of Caution."

209/See Miller, "Federal Excise Taxes: Approaching Deficit Reduction from the Revenue Side" at 27-28. Miller notes there are three approaches to implementing the equity objective: the ability-to-pay principle; the benefit principle; and the sumptuary principle.

The ability-to-pay principle has been used in the United States to justify progressive taxation based on some measure of a taxpayer's economic condition. Two commonly accepted components of the ability-to-pay principle include horizontal equity and vertical equity. Horizontal equity requires that taxpayers in similar economic situations be treated similarly while vertical equity requires that taxpayers in different economic situation be treated differently. See Id., at 28.

The benefit principle states that the tax burden be distributed on the basis of a taxpayer's benefit from, or use of, public services. The sumptuary principle allows society to tax behavior or activities that it deems immoral or antisocial. Miller notes that neither the benefit nor sumptuary principles are used extensively in the present tax system of the United States. See Id.

210/1985 Comprehensive Tax Reform Proposals at 3-5.

211/See 1982 ALI Study at 4-6.

212/See 1985 Comprehensive Tax Reform Proposals at 4-5.

213/See Id., at 5.

214/See Id.

215/See McClure, "Where Tax Reform Went Astray" at 1625.

216/See 1985 Comprhensive Tax Reform Proposals at 6.

217/<u>See</u> Miller, "Federal Excise Taxes: Approaching Deficit reduction from the Revenue Side" at 28. Miller agrees with other economists in stating that only the lump-sum head tax is completely neutral with respect to all economic choices (e.g., between work and leisure, between present and future consumption, and between consumption of various consumer goods). The head tax cannot interfere with a taxpayer's behavior because the taxpayer cannot avoid or reduce the tax by changing his consumption, production, occupation, or work patterns. <u>See Id</u>.

The public finance and economic literature has frequently discussed the point that designing a tax system that would exert no behavioral effects is virtually impossible and, even if such a tax could be devised, it would not satisfy the other general objectives such as equity and the need to raise a substantial amount of tax revenue to finance government operations. <u>See</u> Buchanan, <u>The Public Finances</u> (Richard Irwin, 1965) at 310-311. Buchanan states that a tax which is completely general (i.e., one that applies to all taxpayers in all circumstances) cannot exert any behavioral or economic effects because the taxpayer cannot escape or shift the tax burden by altering his behavior. Buchanan notes that the lump-sum head or poll tax is the closest practical equivalent to such a completely general tax but that such a head tax conflicts with many of the generally accepted objectives of taxation. <u>See Id.</u>, at 311-312.

218/<u>See</u> 1979 AICPA Study; Pugh, "Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and Substance," 35 <u>Tax L. Rev</u>. 359 (1980); and Faber, "The Search for Consistency in Corporate Acquisitions," 13 <u>J. Corp. Tax'n</u> 187 (1986).

219/<u>See</u> Unger, "Gain Recognition and Basis in Acquisitions."

220/<u>See</u> McClure, "Where Tax Reform Went Astray" at 1626.

221/<u>See Id.</u>, at 1624. McClure argues that changes in resource allocation resulting from changes in real income or wealth should not be considered in appraising the neutrality of a tax system.

222/Arthur Andersen & Co., <u>Washington Tax Letter</u>, "The Revenue Act of 1987--Tailoring the Sow's Ear," (No. 87-1, April, 1987) at 3. For a detailed discussion of the use of tax expenditures as compared with direct governmental expenditures, <u>see</u> Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct

Government Expenditures," 83 Harv. L. Rev. 705 (1970).

223/See Simon, "The Budget Process and The Tax Law," 40 Tax Notes (August 8, 1988) at 628-629. Simon states:

> Because tax expenditures are not treated as outlays for budget purposes by the Congress, they are not systematically coordinated with direct expenditures, nor do they receive the same annual scrunity that direct outlays receive in the budget and appropriations process.

Id., at 630.

Simon argues that the historical separation of the process of enacting tax legislation and the federal budget process has resulted in very little coordination between policy makers who must raise tax revenue and others who spend tax revenue. Simon feels that tax expenditures are perhaps the most obvious case where the spending hand may be entirely oblivious to the benefits and burdens imposed by the taxing hand. Simon rejects the traditional argument that more integration of the tax legislation and budget functions would inhibit the development of sensible tax legislation particularly in view of the increasingly revenue-driven demand for more tax revenue in view of massive federal budget deficits.

224/Id., at 632.

225/See Tax Aspects of Mergers and Acquisitions at 13.

226/See Id. See also 1979 AICPA Study.

227/See Id.

228/1985 Comprehensive Tax Reform Proposals at 5.

229/See Id., at 6.

230/Id.

231/See Roberts, "Simplification Symposium Overview: The Viewpoint of the Tax Lawyer" at 6. To a tax accountant or a tax lawyer, the term "complexity" means:

1. A reasonably certain conclusion, in some instances, cannot be determined despite diligent and expert research; and

2. A reasonably certain conclusion can be determined in

other instances only after an expenditure that is excessive in time and dollars.

See Id.

232/See Moore, "Form v. Substance: When Will Courts Respect the Form Of A Transaction?" 66 J. Tax'n 66 (1987).

233/See Eichholz, "Should the Federal Income Tax Be Simplified?" 48 Yale L. J. 1200 (1939) at 1212.

234/See McDaniel, "Simplification Symposium Federal Income Tax Simplification: The Political Process," 34 Tax L. Rev. 27 (1978). Given the many varied factors, institutions, individuals, political philosophies, and sources of influence and power that become involved when tax legislation is considered and enacted by Congress, McDaniel states "the wonder is not that the tax system is complex, but that it remains as comprehensible as it is." Id., at 43. McDaniel states the most frequently mentioned aspects of simplicity include the following:

1. more understandable statutory language;

2. increased ease and efficiency of tax administration;

3. greater certainty in tax planning;

4. more readily understood tax forms; and

5. more coherent resolution of tax issues by the courts.

See Id., at 29.

235/See Id., at 29.

236/Id., at 62.

237/See 1985 Comprehensive Tax Reform Proposals at 6-7.

238/The tax-free reorganization provisions can be justified on wherewithal-to-pay grounds, on neutrality grounds, and on incentive grounds.

239/1985 Comprehensive Tax Reform Proposals at 33-34.

240/Id., at 7.

241/Id., at 33-34.

242/See Shurtz, "A Critical View of Traditional Tax Policy

Theory: A Pragmatic Alternative" at 1665.

243/Id., at 1696.

244/See Id., at 1666.

245/See Id., at 1681.

246/See Id., at 1673.

247/Id.

248/See, e.g., Sneed, "The Criteria of Federal Income Tax Policy," 17 Stan. L. Rev. 567 (1965).

249/Shurtz notes that the goals of stability and economic neutrality are often in serious conflict as seen in the debate over the use of accelerated depreciation systems (e.g., the ACRS system enacted in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981)), and the use of the investment tax credit. Shurtz states that ACRS and the investment tax credit were enacted primarily to encourage capital formation but have been substantially modified or repealed in subsequent tax legislation because of the economic inefficiencies they created. See Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative" at 1672.

See generally, Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?" 16 San Diego L. Rev. 735 (1979).

250/Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative" at 1611.

251/Most commentators agree that the Haig-Simons definition of income stands for the proposition that "income" is the sum of consumption plus the change in value of property for some period of time for some taxpayer.

252/See Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative" at 1670.

253/Shurtz notes: "Because there are no objective criteria pursuant to differences in ability to pay which can be taken into account, the ability-to-pay concept is so ambiguous that it lacks practical content." Id., at 1672.

254/Id., at 1674-1675.

255/The major public policy issues raised by the megamerger wave of the 1980s in the United States are the impact of corporate takeovers: (1) on economic growth; (2) on financial stability; (3) on corporate shareholders; (4) and on corporate governance. These issues are discussed in detail in Rept. of the Chairman of Subcomm. on Telecommunications, Energy, and Finance (U. S. House of Representatives), Corporate Takeovers: Public Policy Implications For The Economy and Corporate Governance, 99th Cong., 2nd Sess. (Comm. Print 99-QQ 1986). It is interesting that the role of the federal income tax laws is mentioned only infrequently in this lengthy report.

256/1983 Hearings on Reform of Corporate Taxation at 138.

257/See Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions."

258/See Sandberg, "The Income Tax Subsidy to 'Reorganizations'" 38 Colum. L. Rev. 98 (1938).

259/See, e.g., Shaw, "Impact of Proposals On Acquisitions Of Closely Held Corporations."

260/The basic elements of comprehensive tax reform plans that continue the use of a progressive income tax system include simplification of the tax system, broadening the tax base, and lowering marginal rates. See Annual Report of the Council of Economic Advisers (Feb. 1985) at 82.

261/See Cannelos, "The Overleveraged Acquisition," 39 Tax Law. 91 (1985) and "Ugly Bears or Clay Pigeons?" Wall St. J. (April 21, 1989) (editorial arguing that Congress should limit deductibility of acquisition indebtedness for hostile takeovers).

262/See Murray, "Brady Suggests LBOs Could Be Curbed By Shifting Tax Deductions to Dividends," Wall St. J. (January 25, 1989) at A4; Birnbaum and Duke, "Tax Writers Move on Plan To Curb LBOs," Wall St. J. (January 26, 1989) at A2; Anders, "Study by KKR Outlines Virtues of Buy-Outs," Wall St. J. (January 23, 1989) at C1; Smith, White, and Ricks, "Wall Street Fears Grow That Congress Will Put Brake on LBOs," Wall St. J. (January 16, 1989) at C1; Jensen, "Is Leverage an Invitation to Bankruptcy? On the Contrary--It Keeps Shaky Firms Out of Court," Wall St. J. (February 1, 1989) at A14; and Burham, "Is Leverage an Invitation to Bankruptcy? Limits on Liability Actually Are What Invite the LBOs," Wall St. J. (February 1, 1989) at A14.

263/See Tax Aspects of Mergers and Acquisitions at 15.

264/See Id. As discussed in Chapter III of this Study, mergers designed to accomplish these objectives include distributive, churning, leveraged, and tax benefit transfer mergers.

265/See Report on Hostile Takeovers at 15. As noted throughout this Study, neither the policy-oriented nor the empirical literature can fully explain why mergers and acquisitions occur. Maloney and McCormick state:

> In one important respect, economic analysis of mergers is incomplete. Considerable attention has been paid to the overall impact of mergers on stockholder wealth, economic efficiency, the operation of capital markets, and the like, but little research has been devoted to delineating the specific causes and effects of any one particular merger. This is especially troublesome when antitrust authorities are charged with assessing the potential effect of every merger. The result has been that mergers are investigated on a case-by-case basis without much theoretical direction. By default, a structuralist or market-concentration doctrine has emerged, but, as many observers have noted, this approach is far from perfect.

Maloney and McCormick, "Excess Capacity, Cyclical Production, And Merger Motives: Some Evidence From The Capital Markets," XXXI J. L. & Econ. 321 (1989) at 327.

266/Steiner suggests three possible standards:

1. A world with no taxes at all. Theoretically, one could compare the allocations of resources in the present world with what would occur in a society with no taxation.

2. A world having corporate income taxes but no special provisions for mergers and acquisitions. Theoretically, one could again compare the allocation of resources in the present world with what would occur in a world with only corporate income taxes.

3. A world with both corporate income taxes and special provisions for acquisitions. This is the most realistic basis for comparing the allocation of resources. This is also the one that has the inherent problem of separating the effects of

incentives for mergers and acquisitions from incentives for corporate diversification.

See Steiner, Mergers: Motives, Effects, Policies at 78.

267/See Auerbach and Reishus, "The Effects of Taxation on the Merger Decision," in Auerbach (ed.), Corporate Takeovers at 157-183. The authors state:

> By focusing exclusively on mergers that occurred, we are able to estimate the size of the tax benefits involved but not the role that these benefits played in the actual merger process. The presence of such benefits is a necessary condition for tax factors to influence merger activity, but not a sufficient one.

Id., at 157. The authors note that without access to confidential tax returns and other data available only to the acquiring and target corporations, researchers must estimate the size and availability of potential tax benefits of mergers. See Id., at 179.

Due to the inability to directly measure the effect of the federal income tax laws on the merger decision, the authors:

> compared the tax characteristics of a sample of merging firms to those of a similar sample of non-merging firms chosen at random and, using both samples, estimated a 'marriage' model of merger activity.

Id., at 178.

The authors studied actual and "pseudomergers" of publicly-held corporations which occurred over the years 1968-1983. The principal conclusions are:

1. Potential increases in interest deductions were not an important factor in influencing merger activity.

2. The acquiring corporation's use of the target's net operating loss and tax credit carryovers appear to exert an insignificant influence on merger activity.

3. The ability of the acquiring corporation to obtain a stepped-up basis for the target's assets without full recognition of gain realized by the target corporation (i.e., the lack of symmetry caused by the General Utilities doctrine) does not appear to strongly influence merger activity.

4. The ability of the acquiring corporation to use its net operating losses and tax credit to reduce the taxable income and tax liability of firms it acquired appears to most strongly influence merger activity.

See Id., at 178-179.

268/Joint Economic Committee Study at 4. The Joint Economic Committee feels the following principles should form an adequate basis for judging among the different approaches to enacting comprehensive tax reform: ability to raise sufficient tax revenue to finance the Federal government; stabilization of the business cycle; promoting horizontal and vertical equity; limiting economic inefficiency; enhancing simplicity; enhancing voluntary compliance; and promoting federalism (i.e., the federal income tax should not impede the ability of state and local governments to raise revenues needed to fulfill their responsibilities within the Federal system of government). See Id., 4-23. To the extent that these principles conflict, the evaluation of comprehensive tax reform proposals will vary depending on which "principles" are deemed to be most important.

269/See, e.g., Comprehensive Reform Proposals at 3 stating:

> The questions of equity, efficiency, simplicity, and the encouragement of specific activities are central to the discussion of whether the present tax system should be changed by enacting one of the comprehensive tax proposals currently being discussed.

270/Treasury I (Vol. 1) at xii. President Reagan's proposals for changes in the taxation of corporations do not differ materially from those contained in Treasury I.

271/The primary benefit of a consumption tax, rather than an income tax, is often stated to be the elimination of the overtaxation of capital income inherent in any income tax system. Use of a consumption tax, rather than an income tax, is discussed in Warren, "Would A Consumption Tax Be Fairer Than An Income Tax?" 89 Yale L. J. 1081 (1980) and Gunn, "The Case For An Income Tax," 46 U. Chi. L. Rev. 370 (1979).

272/The acquisition proposals have been criticized as narrow solutions to technical "lawyer" problems because (1) they do not challenge the basic premise that the tax law should provide tax-free treatment for certain acquisitive transactions at the target corporation and target shareholder and security holder levels and (2) they do nothing to resolve the important debt vs. equity classification issue. In testifying on the Preliminary Staff Proposals, Leon Nad of Price Waterhouse criticized the proposals because they did not completely analyze the conceptual underpinnings of the operative provisions for tax-free reorganizations and did not adequately address the fundamental tax policy issue for acquisitive transactions:

> whether the current reorganization provisions permit nonrecognition treatment with carryover of basis and tax attributes too freely, not freely enough, or appropriately.

1983 Hearings on Reform of Corporate Taxation at 205-206.

The New York Society of CPAs criticized the acquisition proposals because they did not address the debt v. equity issue. See 1985 Hearings on Reform of Corporate Taxation at 354.

273/See, e.g., Gutmann, "The Subterranean Economy," Fin. Analy. J. (1977) at 26; Caplin, "Uncovering the Underground Economy," Wall St. J. (March 31, 1980) at 22; "The Underground Economy's Hidden Force," Bus. Week (April 5, 1982) at 64.

274/See generally Feldstein (ed.), The Effects of Taxation on Capital Accumulation and Pechman, Federal Tax Policy (1987).

275/See Annual Report of the Council of Economic Advisers (Feb. 1985) at 82.

276/See Id., at 86-89.

277/See Kristol, "The Reagan Revolution That Never Was," Wall St. J. (April 19, 1988) at 26. Kristol observes that the "supply-side" reductions in marginal tax rates enacted during the Reagan Administration have been imitated in Britain, Canada, Australia, Germany, and other countries. Kristol asserts the most important and lasting change in political philosophy which occurred during the Reagan Administration was the notion that the principal policy goal of the progressive income tax is to redistribute income and wealth was soundly repudiated. The administration and Congress accepted the principle that the income tax should be used to foster economic growth.

Hibbs agrees with Kristol. Hibbs states that the Reagan Administration's political philosophy for tax, antitrust, regulation of the national securities markets, and other important public policy issues was to achieve economic efficiency as conceived in market terms. Hibbs states that the goal of economic efficiency clearly prevailed over the idea that the federal government should pursue redistributive activities geared to enhancing equity and social justice. See Hibbs, The American Political Economy at 326.

278/Penick characterizes ERTA as one of the most important pieces of tax legislation enacted since the 1954 Code from a tax policy perspective because ERTA implemented the Reagan Administration's political philosophy of using the federal income tax laws to foster economic growth rather than to redistribute income and wealth. ERTA enacted the ACRS depreciation system, reduced marginal tax rates, and provided incentives for business to make capital investment. See Penick, "Evolution of the Federal Tax System: 1954-1983," Federal Tax Policy Memo (1983) at 3.

279/Pub. L. No. 97-248, 96 Stat. 324 (1982).

280/See Berton, Ingersol and Smith, "IRS Widens Study of Safe-Harbor Leases," Wall St. J. (September 6, 1988) at 2. The "safe-harbor" leasing provisions enacted in ERTA allowed corporations which could not immediately utilize certain deprecation deductions and investment tax credits to "sell" them to other corporations though certain sale and leaseback arrangements. Safe-harbor leasing is discussed in Padwe and Green, "Highlights of the Economic Recovery Tax Act of 1981," 12 Tax Adviser 644 (1981); Levin and Cohn, "The new leasing rules--get them while they're hot," 13 Tax Adviser 68 (1982); and Levin and Cohn, "Equipment leasing under TEFRA: new restrictions and new opportunities," 13 Tax Adviser 658 (1982).

281/See Hibbs, The American Political Economy (at 285) who states:

> ACRS was so generous to business firms that the dollar value of tax deductions and credits typically exceeded the tax liabilities on the extra income produced by investment in new equipment. In other words, the effective marginal tax rate on new equipment was in many cases negative.

282/See Id., at 292-293.

283/See generally Knight, Knight, and McGrath, "Double

Jeopardy: The AMT And FASB 96," 167 J. Acct. 40 (1989).

284/See, e.g., 1985 Hearings on Reform of Corporate Taxation at 144-147 (statement of James Eustice).

285/See Bloom, "Corporate Tax Changes in the Revenue Act of 1987," 15 J. Corp. Tax'n 138 (1988).

286/See, e.g., Baldasaro and Hoops, "Tax Act of 1986--Corporate Changes," LVI CPA J. 28 (1987). These commentators suggest that the changes made by the TRA of 1986, particularly the repeal of General Utilities, are likely to subject both the ordinary income and long-term capital gains of corporate taxpayers to double taxation to a much greater extent than was the case under the 1954 Code. The 1986 code will thus reduce the unofficial integration in the 1954 Code.

287/See, e.g., Barder and Stewart, Capital Gains and Losses After The Tax Reform Act of 1986," 65 TAXES 125 (1987) and Faber, "Capital Gains v. Dividends: Is The Battle Still Worth Fighting?" 64 TAXES 865 (1986).

288/Virtually all studies of the effects of the corporate income tax in the Unites States advocate a general reduction in corporate tax rates as one method of reducing the distortions in behavior caused by the existence of a separate corporate tax assessed on "taxable income" of the corporation. See, e.g., Comprehensive Reform Proposals at 20-22. One problem with such a "shotgun" approach is that it is not at all clear based on either economic theory or empirical studies that the significant variations in after-tax return on physical and capital assets observed under the 1954 Code, which were a function of how the assets are financed, the inflation rate, the holding period, the presence or absence of special provisions for long-term capital gains, and other factors, will be resolved by simply lowering corporate tax rates. See Auerbach, "The Corporation Income Tax," in Pechman (ed.), The Promise of Tax Reform at 65-76.

289/Many influential commentators including the Council of Economic Advisers believe the federal government generally and federal income tax system specifically should play as neutral a role as possible in the treatment of acquisitive transactions. See, e.g., Chapter 6 "The Market for Corporate Control" in Annual Report of the Council of Economic Advisers (Feb. 1985) at 187-216. The acquisition proposals are based on the proposition that in the absence of convincing empirical evidence that acquisitive transactions harm the economy the federal income tax system should neither encourage nor discourage acquisitive transactions and should not base tax consequences of such transactions on the legal form of the transaction. See Subchapter C Revision Act at 37.

290/The provisions of Sec. 1060 enacted in the TRA of 1986 to provide uniform rules for allocating the price paid for target stock in taxable asset acquisitions and Sec. 338 transactions are discussed in Chapter V of this Study. Because Sec. 1060 makes it more difficult to avoid allocating part of the purchase price to nondeductible goodwill or going concern value, many commentators believe Sec. 1060 will discourage taxable asset acquisitions and Sec. 338 transactions. See generally Auster, "Allocation of Lump-Sum Purchase Price upon the Transfer of Business Assets After Tax Reform," 65 TAXES 545 (1987).

291/See Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986."

292/See Freeman, "Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsman of the Repeal of General Utilities," 64 TAXES 962 (1986).

293/See Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Prediting the Near Future" at 37-137.

294/Id., at 37-77.

295/See Id., at 37-9. Two of the most important manifestations of the eroding tax base are the use of master limited partnerships and the issuance of junk bonds in acquisitive transactions. See Id., at 37-9 through 37-12.

296/See Id., at 37-12. According to the radical view, the ability of taxpayers to combine income or deductions of various corporate entities is a significant tax policy issue because it makes it difficult for the taxing authorities to identify the taxpayer. The use of adjustable rate preferred stock to arbitrage differing tax rates and the ability of loss corporations to acquire the assets or stock of profitable corporations to absorb otherwise nondeductible losses are two of the more important manifestations of difficulties in identifying the taxpayer. These issues are discussed at 37-12 and 37-13. The general problems of tax arbitrage are discussed in Shakow, "Confronting The Problem Of Tax Avoidance," 43 Tax L. Rev. 1 (1987).

297/See Id., at 37-14. According to the radical view, there are a number of techniques which account for the avoidance of taxation at the shareholder level. One of the current techniques is share repurchases (whether or not financed by junk bonds) in which much of the cash the shareholder receives from the corporation is a tax-free return of basis. This issue is discussed in Shoven, "The Tax Consequences Of Share Repurchases and Other Non-dividend Payments to Equity Owners," in Summers (ed.), Tax Policy and the Economy at 29-54.

Many commentators believe that the fundamental tax problem for leveraged buyouts and other recent corporate restructuring transactions is the taxation of corporate distributions and not the taxation of acquisitive transactions. See, e.g., Warren, "Recent Corporate Restructuring And The Corporate Tax System," 42 Tax Notes 715 (February 6, 1989). Some commentators argue that, in the aggregate, leveraged buyouts generate a net increase in tax revenues for the federal government. These commentators do not agree that the corporation distribution provisions of the tax law are being seriously or systematically abused. See, e.g., Jensen, Kaplan and Stiglin, "Effects Of LBOs On Tax Revenues Of The U.S. Treasury," 42 Tax Notes 727 (February 6, 1989).

298/See Id., at 37-15.

299/The Tax Reform Act of 1986 reflects the basic principles of both Treasury I and II: lower marginal tax rates; broadening the personal and corporate tax bases; and equalization of the marginal tax rates on alternative income producing activities. See Annual Report of the Council of Economic Advisers (Jan. 1987) at 81-82.

300/Not all commentators agree that the recommendations made in Treasury I and II represented comprehensive tax reform. Although he characterizes Treasury I as one of the most thoughtful tax reform proposals to date, Brannon states: ". . . from the standpoint of analysis of problems of income tax, they are essentially gimmicks that move tax burdens around with principal concern for political appeal, i.e., having more winners than losers." See Brannon, "Tax Loopholes As Original Sin: Lessons From Tax History" at 1780.

301/As discussed throughout this Study, the principal reason why acquisitive transactions pose fundamental tax policy issues is the absence of an comprehensive annual shareholder level tax on the increase in the value of their corporate shares. Because the corporation and its shareholders have potential and conditional tax liabilities at the time of an acquisitive transaction, the tax law must provide special recognition and basis rules for acquisitive transactions. The traditional view that the tax consequences should flow from the legal form of the transaction and the fact that corporations and their shareholders are generally treated as separate and distinct taxpayers account for much of the difficulty in drafting tax provisions that achieve the major goals and subgoals of comprehensive tax reform for acquisitive transactions.

302/Fullerton and Henderson conclude that the enactment of either Treasury I or Treasury II would reduce the economic inefficiency of the tax system as compared to the 1954 Code. The principal reasons are:

1. The tax base for all taxpayers is defined in a manner which more closely approximates economic income.

2. The expanded tax base allows the imposition of lower marginal tax rates.

3. The effective tax rate on returns from alternative assets, sectors of the economy, and industries will be more uniform which will produce a superior investment mix and increase national output.

See Fullerton and Henderson, "The Impact of Fundamental Tax Reform on the Allocation of Resources," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 401-443.

303/McClure, "Where Tax Reform Went Astray" at 1621. McClure notes that a major problem in attempting to enact comprehensive tax reform is that preferential treatment to which economists object such as the deduction for home mortgage interest, state and local taxes, and charitable contributions, are quite popular with the public. See Id., at 1637.

304/In addition, the all or nothing approach was deemed to be necessary for the radical proposals to be politically acceptable. The all or nothing approach was also felt to limit the power of lobbyists to carve out exceptions. McClure states:

> Treasury I was based on the proposition that fun-

damental tax reform was most likely to occur if enacted in one comprehensive act. Fundamental tax reform would make possible substantial reductions in horizontal inequities and distortions of resource allocation. If carefully examined, these advantages of reform might appeal to the general public. Elimination of all preferential treatment would create important reductions in marginal tax rates, a benefit that is far more understandable to the public than economists' esoteric arguments about reduced distortions and horizontal inequities. Moreover, fundamental tax reform would simplify economic decision-making, as well as administration and compliance, producing benefits which the public could readily appreciate. In short, it might be possible to rally the public behind fundamental tax reform in a way that would be impossible if tax reform were to take an incremental approach.

Id., at 1637-1638.

305/See, e.g., Ernst & Whinney, Washington Tax Reporter (December 1984) at 1-3.

306/McClure feels that the most fundamental proposal in Treasury I was the proposed inflation adjustment for depreciation allowances, cost of goods sold, capital gains and interest income and expense. See McClure, "Where Tax Reform Went Astray" at 1628-630. McClure argues that unless the tax system provides appropriate inflation adjustments, "it is meaningless to speak of uniform and consistent taxation of all income." McClure also notes that the use of ad hoc means to attempt to deal with inflation, such as the exclusion of part of long-term capital gains and the use of a LIFO inventory method, cannot adequately compensate for inflation because the accuracy of the adjustment method depends on the actual rate of inflation experienced. Treasury I took the position that the only way to avoid the use of these ad hoc measures and associated problems in the context of an annual income tax was to explicitly allow for inflation in the measurement of business and investment income. See Id., at 1628-1629.

307/See Treasury I (Vol. 1) at xii-xv. The principal changes proposed in Treasury I are discussed in more detail in Chapter 6, "Basic Taxation of Capital and Business Income" at 97-121 and in Treasury I (Vol. 2) at 127-201.

308/Tressury I (Vol. 1) at 1.

309/See Id. See generally Brannon, "Tax Loopholes As

Original Sin: Lessons From Tax History."

310/King concludes that enactment of either Treasury I or Treasury II would move the corporate tax base closer to economic income as compared to the 1954 Code and would therefore help to make the tax law less economically inefficient. See King, "The Cash Flow Corporate Income Tax," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 377-400.

311/Treasury II at 117.

312/See Id., at 121.

313/See Id., at 134.

314/See Id.

315/The principal changes proposed by Treasury II are discussed in Treasury II at 117-196.

316/McClure, "Where Tax Reform Went Astray" at 1658-1659.

317/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" and Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform."

318/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 822. As discussed in the text supra, the 1986 Code implements the weak form of taxation for acquistive transactions.

319/See Id., at 821.

320/Generally under the 1986 Code, if an acquiring corporation purchases the assets of the target in a nonreorganization transaction the target corporation must immediately recognize all gain realized under Section 336. The shareholders of the target corporation will recognize any gain realized as a result of liquidating distributions under Section 331. The acquiring corporation will take a cost basis in the target assets acquired. See generally Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics Not Being Basic."

321/As was also the case under the 1954 Code, if the acquiring corporation acquires a controlling interest in the stock of the target corporation in a nonreorganization transaction or simply purchases the target stock and does not make a Section 338 election, the acquiring corporation takes a cost basis in the stock of the target corporation. Because the tax bases of the target corporation's assets do not change, the target's tax attributes remain intact, and the target corporation recognizes no gain, the transaction is a carryover basis transaction. See generally Unger, "Gain Recognition and Basis in Acquisitions."

An important, but not yet fully resolved, tax policy issue is whether the 1986 Code's approach of taxing the gain realized and recognized by the acquiring corporation when the assets transferred from the target corporation are sold or exchanged imposes too heavy a tax burden given the fact that the target shareholders have already paid a tax on the appreciation in the value of the target stock in the acquisitive transaction. This policy issue is the converse of the General Utilities controversy: is a required carryover basis for target assets in the hands of the acquiring corporation sufficient to preclude taxing the target corporation and its shareholders on gain realized in an actual or deemed liquidating sale or distribution of appreciated assets? See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 822.

322/If the Section 338 election under the 1986 Code is made the tax consequences are very similar to a taxable asset purchase. The target corporation recognizes any gain realized and the acquiring corporation takes a cost basis in the target assets acquired. Commentators suggest that in most Section 338 transactions, the acquiring corporation effectively pays the tax cost of the basis step-up and will adjust its offering price for the target corporation stock accordingly in order to achieve the desired after-tax rate of return.

323/Under the 1986 Code, the transferor (target) corporation does not recognize gain or loss upon receipt of consideration from the acquiring corporation. For all acquisitive tax-free reorganizations except the "B" reorganization, the acquiring corporation takes a carryover basis in the target assets and "acquires" the target's tax attributes as provided in Sections 381, 382 and 383. In a "B" reorganization, the acquiring corporation takes a basis in the stock of the target corporation equal to the sum of the bases in the target's stock of the former target shareholders.

Because of the repeal of the General Utilities doctrine, the target corporation may recognize a gain upon making distributions of its own appreciated assets in the overall transaction (e.g., assets not transferred to the acquiring corporation). The stockholders and security holders of the target corporation determine their recognized gains and tax bases in consideration received either directly from the acquiring corporation or indirectly from the target corporation under Sections 354, 356, and 358, none of which was changed by the TRA of 1986.

The TRA of 1986 did not radically alter the 1954 Code provisions for tax-free reorganizations except to adjust Section 361 for the repeal of the General Utilities doctrine. Section 361(a) of the 1986 Code provides that the target corporation does recognize any gain or loss on the exchange of its property pursuant to the plan of reorganization. Section 361(a) of the 1954 Code provided that the target corporation would recognize no gain or loss upon receipt of stock or securities of the acquiring corporation. If the transferor corporation received boot from the acquiring corporation, Section 361(a) of the 1954 Code required the transferor corporation to distribute it to its shareholders to avoid the recognition of gain. Section 361(a) of the 1986 Code does not include such a distribution requirement because it determines the corporate level tax consequences when the transferor corporation makes distributions.

Section 361(b) of the 1986 Code determines the extent to which the transferor corporation will recognize gain upon the distribution of acquiring corporation stock and securities and the other properties of the acquiring corporation (i.e., those which were not transferred to the acquiring corporation). Section 361(b)(3) of the 1986 Code provides that the transferor corporation will recognize no gain or loss upon its distribution of stock or securities of a corporation which is a party to the reorganization to its shareholders. Section 361(b) of the 1986 Code provides that a transfer of stock and securities of the acquiring corporation to the creditors of the transferor corporation will not cause recognition of gain or loss. This rule is based on the assumption that the stock and securities were distributed to creditors as part of the plan of reorganization. Section 361(b)(2) of the 1986 Code leads to the result that the transferor corporation will generally take a fair market value basis in any boot received from the acquiring corporation. Thus the target corporation's distribution of such boot will generally not result in recognition of gain to the target corporation.

Section 361(c) of the 1986 Code reflects the repeal of the General Utilities doctrine. Section 361(c) of the 1986 Code provides that if the target corporation holds appreciated property which was not transferred to the acquiring corporation, either a sale of the property by the target corporation or an in-kind liquidating distribution of the property to the shareholders of the target corporation will result in the recognition of gain by the target corporation to the extent of the gain realized.

324/See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 821.

325/See Id., at 824-832. As discussed in Chapter III of this Study, many of these transactions have been eliminated or rendered much less attractive by the Revenue Act of 1987. Such transactions discussed and criticized by Zolt from a tax policy perspective include the mirror subsidiary technique, the tiered-mirror technique, the investment basis adjustment technique (sometimes referred to as Son of Mirrors), Sec. 304 transactions, and Sec. 355 transactions. Zolt observes: "A strong argument can be made that with the elimination of the rate preference for capital gains, the statutory and judicial restrictions on the use of Section 355 no longer make sense." Id., at 831.

326/See generally Warren, "The Relationship and Integration of Individual and Corporate Taxes," 94 Harv. L. Rev. 719 (1981).

327/See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium" at 839-840.

328/Id., at 875-875. Zolt notes that from a tax policy perspective, the 1986 and 1987 Acts will force taxpayers to seek various "self-help" integration measures to integrate the corporate and individual tax burdens including operating businesses as partnerships or S corporations and increasing the amount of debt in the corporation's capital structure. Zolt asserts: "Tolerating self-help integration, however, is hardly a rational approach to the problems created by the imbalance in the corporate tax system." Id., at 875.

329/See Id., at 854. Other changes which also upset the rough equilibrium which existed under the 1954 Code include strengthening the corporate alternative minimum tax provisions, imposition of the built-in gain tax for S corporations, limitations on the use of net operating losses, and changes in tax accounting rules which make it more difficult for all taxpayers to defer the recognition of income and the payment of federal income taxes.

330/As discussed in this Chapter, the tax literature uniformly supports reducing marginal tax rates and narrowing the range of effective tax rates for various industries and assets to make the tax law less economically inefficient.

331/See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium" at 855.

332/See generally Levun, "Partnerships--The Preferred Form of Doing Business After The Tax Reform Act of 1986," 65 TAXES 600 (1987).

333/See Zolt, "Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium" at 871.

334/Id., at 877.

335/The 1982 ALI Study (at 3) states:

> The Acquisition Proposals are on the whole quite independent of the integration question. The issues with which they deal would persist under any of the forms of integration widely discussed, and the proposals themselves would still represent sound solutions to those issues. Some adoptions might be appropriate for some particular forms of integration, and an effort has been made to identify these in the comments, but they are few in number and do not go to the heart of the Acquisition Proposals.

336/See. e.g., 1983 Hearings on Reform of Corporate Taxation (statement of John Nolan) at 160.

337/Id., at 158-159.

338/1985 Hearings on Reform of Corporate Taxation at 144. Eustice stated that under the 1954 Code, taxpayers and their advisers must often find their way through an "incredible minuet of transactional selectivity in order to find the right letter of the alphabet" to obtain the desired tax result. See Id., at 143.

339/See Id., at 147.

340/See Id., at 520-521.

341/See Id., at 329. See also 380-383 (statement of Byrle Abbin of Arthur Andersen & Co.). Abbin noted that the repeal of General Utilities in the context of taxable acquisitions is an unwarranted expansion of the corporate tax base. Abbin asserted that the practical effect of the repeal of General Utilities will be to eliminate taxable acquisitions because this type of acquisition can rarely be justified on a present value basis. Because the acquiring corporation would rarely be able to obtain a tax basis for its investment in the target in a carryover basis transaction equal to the cost of its economic investment, Abbin argues that the acquiring corporation will bid down the price offered for target assets or stock in order to earn its target after-tax rate of return. Abbin also testified that repealing General Utilities will create an undesirable bias in the tax law: publicly-held corporations will be much more likely to acquire privately-held corporations than vice versa.

342/See Id., at 465 (statement of George Brode, a tax lawyer). Brode also asserts:

> There have been many well intentioned proposals spawned by theoreticians which under the guise of 'tax consistency,' 'simplicity,' or 'fairness' have inundated the tax community with their complexity or failed implementation (e.g., carryover basis, the 1976 Section 382 net operating loss rules, and Section 338). This endless spate of 'make-work' legislation must stop.

Id.

343/See Posin, "Taxing Corporate Acquistions: Purging Penelope's Web" at 1403.

344/See Id., at 1397.

345/Id.

346/Id.

347/Id., at 1408.

348/1985 Hearings on Reform of Corporate Taxation at 161.

349/Ginsburg, "Special Topics In The Acquisitions Area" at 160.

350/Edwin Cohen testified that the consistency rules contained in the Preliminary Staff Proposals were not well thought out with respect to the potential differences in tax treatment of corporations operating through divisions as compared to subsidiaries:

> The [1983 Staff] report indicates that a corporate

purchaser of assets of another corporation would have to elect carryover basis for all of the assets acquired from a particular corporation or elect cost basis for all those assets; but if in the same transaction it were to acquire the assets of a parent corporation and those of a subsidiary, it could elect cost basis for the assets of one corporation and carryover basis for those of the other corporation.

We are concerned that this rule might create serious uncertainty as to whether particular assets should be held by a wholly-owned subsidiary, rather than by its parent corporation, in order to make the choice of carryover or cost basis available to a prospective purchaser in the event the business is sold. Corporate structures would be influenced by this prospective tax advantage rather than being dictated by business needs and convenience. The policy of tax law for some time has been to equate the tax burden on corporations operating through divisions with those operating through subsidiaries, a policy which we believe is proper and which would be contravened by this proposal.

These problems with respect to subsidiaries require careful thought. If there are different tax results on sales of property depending on whether assets are held in subsidiaries or by a parent corporation, not only would mere differences in corporate structures produce widely different tax results, but in addition we would revive the problem of step transactions that led the Congress in adopting the Internal Revenue Code of 1954 to install the present rules. If taxes could be saved by having a property owned in a subsidiary, attempts would be made to transfer property to subsidiaries shortly before a sale, leading to I.R.S. challenges as to the efficacy of a last minute transfer. Similarly, liquidations of subsidiaries shortly before a sale would lead to unsettled results. These difficult issues, largely set to rest in 1954, should not now be revived.

1983 Hearings on Reform of Corporate Taxation at 180.

351/1985 Hearings on Reform of Corporate Taxation at 168.

352/See Id., at 148.

353/Id., at 148-149.

354/James Roche testified that the proposal under which the basis of subsidiary stock held by a parent corporation would always equal the net adjusted basis of a controlled subsidiary's assets (i.e., the mirror basis rule), even where the parent and subsidiary do not file a consolidated tax return, would not produce neutral results for cost basis and carryover basis acquisitions. The carryover basis election would be doubly penalized: an acquiring corporation receives no basis step-up in target assets, and in turn, no step-up in the original basis of subsidiary stock. See 1983 Hearings on Reform of Corporate Taxation at 282-282.

Roche also stated that this rule is a significant departure from the long-standing tax policy that a corporation and its shareholders are two separate and distinct taxpayers and would unduly penalize acquiring corporations which make a carryover basis acquisition:

> As a result, if an acquiring corporation makes a carryover basis election with respect to a qualified stock acquisition and the fair market of the consideration received by former target shareholders exceeds the inside basis of target assets, acquiring corporation will permanently lose basis in target stock. If acquiring corporation subsequently sells target stock, it will be required to pay tax, in part, on a return of capital.

Id., at 282.

355/Leduc, "Current Proposals To Restructure The Taxation of Acquisitions and Dispositions: Substance and Process" at 43. Leduc also asserts that the mirror basis rules for carryover basis acquisitions of target stock are potentially unfair:

> Under the mirror basis rule, the stock basis of the transferee corporation will be adjusted to reflect the carryover basis of the acquired assets. By this proposal, coupling a carryover basis election with a cash purchase yields the perhaps surprising result that basis disappears if the carryover basis is lower than the amount of cash paid. Correspondingly, of course, basis may be created if the fair market value of the acquired assets is lower than their historic basis.
>
> It is important to recognize just how harsh the result proposed by the staff is. . . . The tax law, after all, ordinarily gives an all cash unrelated purchaser a basis in purchased property equal to the

> cash paid. The mirror basis proposal, in the case of a carryover basis acquisition, would, by conforming the stock basis to the asset basis, reduce the basis below cost. Although not fully explored in the Staff Report, there are strong simplicity merits for the position taken.

Id., at 43-44.

356/The final acquisition proposals were issued in May 1985 prior to the enactment of the Tax Reform Act of 1986 in October 1986. The Act states that qualified acquisitions were to include liquidating sales under the 12-month complete liquidation provisions of Sec. 337 due to the desire to define "qualified acquisitions" broadly to include all types of economically equivalent acquisitive transactions under the 1954 Code and to include those statutory provisions which codified the now repealed General Utilities doctrine. The Tax Reform Act of 1986 repealed Secs. 336 and 337 which provided that a liquidating corporation would generally not recognize gain or loss upon a in-kind distribution or sale of its assets as part of a complete liquidation. Secs. 336 and 337 thus codified the now repealed General Utilities doctrine. Sec. 337 of the 1986 Code provides special nonrecognition rules for the upstream liquidations of controlled subsidiaries into their parent corporations in which the subsidiary generally does not recognize gain and the parent generally takes a carryover basis in the subsidiary's assets. Because Sec. 337 of the 1986 Code deals with a much different situation than Sec. 337 of the 1954 Code, the intention of the Subchapter C Revision Act suggests that qualified acquisitions would not include transactions described in Sec. 337 of the 1986 Code.

357/1985 Hearings on Reform of Corporate Taxation at 324-325.

358/See Id., at 200.

359/See Id., at 143.

360/See Id., at 494-495 (statement of the Corporations Committee of the Tax Section of the Florida Bar Association).

361/See 1985 Hearings on Reform of Corporate Taxation at 202 (statement of M. Aidinoff).

362/Leduc, "Current Proposals To Restructure The Taxation of Corporate Acquisitions and Dispositions: Substance and Process" at 55-56.

363/See Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1398-1399.

364/Id., at 1400.

365/See, e.g., 1983 Hearings on Reform of Corporate Taxation at 415 (statement of Deloitte Haskins and Sells).

366/See Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger and Acquisition Provisions" at 617-618.

367/See Id., at 618.

368/Id., at 634-635.

369/1985 Hearings on Reform of Corporate Taxation at 149.

370/1983 Hearings on Reform of Corporate Taxation at 465.

371/Id.

372/See Tax Aspects of Mergers and Acquisitions at 52.

373/See 1985 Comprehensive Tax Reform Proposals at 143.

374/See Id., at 353 (statement of New York Society of CPAs).

375/See Id., at 198. Aidinoff observed that well-advised taxpayers can easily avoid "mandatory" tax-free reorganization treatment under the 1954 Code by poisoning the consideration with excess boot and can effect a carryover basis election by simply purchasing control of the target's stock without making a Sec. 338 election.

376/See Id.

377/Jacobs, "Reorganizing the Reorganization Provisions," at 419-420.

378/1985 Hearings on Reform of Corporate Taxation at 322.

379/See Id., at 325.

380/Id., at 324-325.

381/The AICPA stated there is no doubt that:

> the passage of this Act will result in the reduction in the value of most corporations--both large and small--and of the shares of stock owned by investors

in these corporations. Because cost basis generally represents a benefit to the buyer, the value of the lost benefit will be effectively imposed on the selling shareholders through a reduction in the purchase price of their shares.

In light of the substantial cost to shareholders, we believe that further reduction or outright repeal of the General Utilities doctrine should be supported by compelling evidence of distortions caused by General Utilities in existing or proposed tax laws. We believe the arguments advanced by the Report in favor of repeal (or further reduction) of the General Utilities doctrine fall far short of this standard.

Id., at 327-328.

382/See Id., at 329.

383/See Id., at 323.

384/See Id., at 327.

385/See Id., at 322. The AICPA stated:

In connection with the cost basis election, the repeal of General Utilities is antithetical to the objectives of the Act. While in form, the relative freedom to elect corporate level tax consequences represents a major innovation introduced by the Act, the election immediately losses any practical significance as a result of the Act's reversal of the General Utilities doctrine. Put simply, this reversal means that a decision to elect cost basis is premised on a taxpayer's willingness to pay a dollar of tax today to get, at most, a dollar of savings at some point in the future. It is clear that these terms will be unacceptable to an acquiring corporation which will be obliged to accept by default the carryover basis treatment now mandated in the case of tax-free reorganization by current law. For this reason, the proposed corporate cost basis election as well as the existing election to treat taxable stock acquisitions as asset acquisitions now provided by section 338 will be lost.

Id., at 325-326.

386/Id., at 328-329.

387/See 1985 Hearings on Reform of Corporate Taxation at

353 (statement of the New York Society of CPAs asserting that there is no logical reason to continue the linkage of corporate and shareholder level tax consequences as is done for tax-free reorganizations under the 1954 Code).

388/See Id., at 322. As discussed in the text supra, the AICPA strongly disagreed that the enactment of Proposal Four should be tied to such "conceptually unrelated" issues as the repeal of the General Utilities doctrine.

389/See Id., at 192 (statement of M. B. Aidinoff).

390/See Id., at 144-145.

391/See Id., at 437.

Endnotes--Chapter V

1/Much of the recent empirical literature is summarized in Krinksy, Rotenberg and Thornton, "Takeovers--A Synthesis," 7 J. Acct. Lit. 243 (1988) The authors conclude that with the exception of tax incentives, "empirical [event] studies have not convincingly identified underlying motivations in [corporate] takeovers. Whatever the motivations, however, takeovers appear to have a significant impact on the wealth of security holders [shareholders of the target firm]." Id., at 248. The authors also state:

> The burgeoning literature on business combinations encompasses several related disciplines. There appear to be synergies available in combining relevant findings to sharpen the focus of future research.

Id., at 274.

2/See Warren, "Recent Corporate Restructuring And The Corporate Tax System," 42 Tax Notes 715 (February 6, 1989); Graetz, "The Tax Aspects of Leveraged Buyouts And Other Corporate Financial Restructuring Transactions," 42 Tax Notes 721 (February 6, 1989); Jensen, Kaplan and Stiglin, "Effects of LBOs On Tax Revenues Of The U.S. Treasury," 42 Tax Notes 721 (February 6, 1989); and Jones, "House Taxwriters End LBO Hearings; Prospects of Bill This Year Unclear," 43 Tax Notes 930 (May 22, 1989).

3/See generally Buchanan, Rowley, and Tollison (eds.), Deficits (Basil Blackwell, 1987).

4/See generally Sachs, "Subchapter C Overlap Problems," 40 Inst. on Fed. Tax'n (1982) at 48-1 and Willens, "The Significance of Form: Some Subchapter C Manifestations," 5 J. Corp. Tax'n 72 (1985).

5/See the discussion in Chapter III of this Study.

6/See, e.g., Roberts, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (1980) at 416 (asserting that the tax-free acquisitive reorganization provisions can only be simplified by elevating the role of legal form and rejecting long-held notions of equity or fairness).

7/Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web," 133 U. Penn. Law Rev. 1335 (1985) at 1405-1406.

8/See Levmore, "Recharacterizations And The Nature of Theory in Corporate Tax Law," 136 U. Penn. L. Rev. 1019 (1988). Levmore defines a recharacterization as the process by which the Service or the courts rename or recast a taxpayer's completed transactions. Levmore argues that in absence of a normative theory, decisions should be made by both the courts and the IRS based on positive theories that are complete, consistent, brief and direct because (1) such an approach will encourage judicial restraint and (2) the inherent inseparability of positive and normative concerns. Id., at 1063-1066.

Levmore makes a number of interesting observations about the differences between positive and normative legal theories, particularly those unique to corporate tax law. He notes that there are many reasons why the federal income tax law, particularly those transactions governed by Subchapter C, is based almost exclusively on positive, rather than normative, theories. He notes that positive theories are retrospectively descriptive "because they reveal the rule structure of past decisions in a way that is, perhaps, convincing and elegant." Id., at 1059.

A positive theory is also predictive in that it may help to foretell the outcomes of future cases. Id. Levmore continues:

> Positive theories and normative values are sometimes fairly separable. This is especially, or even uniquely, true in corporate tax law where rules and decisions are almost necessarily devoid of a normative foundation and are especially arbitrary. Corporate tax law is arbitrary, and like most of American tax law, it requires a specific recognition event before it taxes appreciation in asset values and because it regards corporations as taxable entities that are distinct from their shareholders. These features are best labeled arbitrary, rather than unfair or inefficient, because it is not entirely clear that alternative rules would be any more ef-' ficient or fair. The point is not to 'defend' the fundamental rules of the tax system as merely arbitrary, but rather to note that because the rules are arbitrary, it is virtually impossible to develop normative arguments about questions that arise as a result or in the shadow of these basic starting points. The nature of corporate tax law often defies normative argumentation.

Id., at 1061-1062.

9/Eustice, "A Guide Through The Mine Field Of Corporate Acquisitions," 43 Tax Notes 1045 (May 22, 1989) at 1045. Eustice continues:

> Much of a tax professional's waking life is a constant quest for intelligent information that is both accurate and up-to-date. Nowhere is this quest more avid, and arduous, than in the area of corporate-shareholder taxation, possibly the most intricate subset of interconnected legal rules to be found in the general income tax regime, which is itself fearsomely complex. 'Information' is abundant here, some would say even excessively so, especially when one considers not only the extensive collection of primary sources (i.e., the tax 'raw materials'consisting of statutes, regulations, rulings, and court decisions), as well as the voluminous corpus of secondary sources (e.g., books, periodicals, tax services, etc.). But the problem with all this information is how to find one's sought-after answer in the boundless sea of 'authorities' and, once having found it, how to apply that answer to the question at hand.

Id.

10/Jacobs, "Reorganizing the Reorganization Treatment" at 416. Cf. Shurtz, "A Critical View of Traditional Tax Policy Theory," 31 Vill. L. Rev. 1665 (1986) (asserting that no comprehensive tax reform can be accomplished using the traditional policy objectives of equity, simplicity, and economic efficiency).

11/See, e.g., Kaden and Wolfe, "The Savings and Loan Tax Shelter," 43 Tax Notes 851 (May 15, 1989) (discussing the central role that the federal income tax law plays in FSLIC-assisted acquisitions of financially troubled savings and loan associations and the fact that such FSLIC-assisted transactions are one of the few Congressionally sanctioned tax benefit transfer transactions).

12/See, e.g., Auerbach, "The Effects Of Reducing The Capital Gains Tax," 43 Tax Notes 1009 (May 22, 1989); Stein, "The Taxation Of Realized Gains," 43 Tax Notes 1013 (May 13, 1989); and Walker and Bloomfield, "The Case For The Restoration Of A Capital Gains Tax Differential," 43 Tax Notes 1019 (May 13, 1989).

13/See Leduc and Gordon, "Two Visions of Subchapter C: Understanding The Tax Reform Act of 1986 and the Revenue Act of 1987 and Predicting the Near Future," 46 Inst. on Fed. Tax'n (1988) at 37-153.

14/Thompson, "A Suggested Alternative Approach To The Senate Finance Committee Staff's 1985 Proposals For Revising The Merger And Acquisition Provisions," 5 Va. Tax Rev. 599 (1986) at 660.

15/Even those commentators who favor the enactment of the acquisition proposals note their complexity. The proposed language contained in the Act runs 130 pages. See Subchapter C Revision Act of 1985 at 77-208. The "technical explanation" of the changes proposed by the Act runs 45 pages. See Subchapter C Revision Act of 1985 at 211-255.

16/Lobenhofer notes that one important reason why Congress did not enact the acquisition proposals in the Tax Reform Act of 1986 was a concern that introducing such radical changes in Subchapter C in addition to the other major changes in the TRA of 1986 might have significant unexpected economic consequences. See Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences of Incomplete and Unexpected Tax Reform," 4 Akron Tax J. 153 (1987) at 179.

17/As discussed in Chapter IV of this Study, Leduc notes there were very significant technical and political reasons why the acquisition proposals and the repeal of the General Utilities doctrine should not have been separated. See Leduc, "Current Proposals To Restructure The Taxation Of Corporate Acquisitions And Dispositions: Substance And Process," 22 San Diego L. Rev. 17 (1987) at 66.

For a discussion of how public choice economics can be used to explain the existence of certain tax policies and specific laws in the United States, see Lee, "Deficits, Political Myopia, and the Asymmetric Dynamics of Taxing and Spending," in Buchanan, Rowley, and Tollison (eds.), Deficits at 289-309.

18/See Price Waterhouse, U.S. Tax Views & Reviews (April 1988, No. 88-2) at 3 (because virtually any deficit reduction program must include raising federal income taxes, many Congressmen are reluctant to enact major tax reform legislation in a Presidential election year) and Simon and Simmons, "The Future of Section 355," 40 Tax Notes 291 (July 18, 1988) (arguing that the current Congressional paranoia about not enacting revenue-losers will not result in more rational tax policies).

19/As discussed in Chapter IV of this Study, a few commentators, notably the American Institute of Certified Public Accountants (AICPA), strongly disagreed with the proposition that repealing the 1954 Code provisions which codified the General Utilities doctrine would be a panacea for much of what was wrong with Subchapter C of the 1954 Code. The AICPA strongly expressed its opinion that the repeal was both unnecessary from a tax policy perspective because it focused on the wrong issues and discriminatory because it would primarily affect smaller and closely-held corporations. The AICPA argued that when Congress codified General Utilities in the 1954 Code it was not at all concerned with the issue of whether it would unduly encourage corporate takeovers. The AICPA stated that even in the "megamerger" world of the 1980's, no one had yet made a persuasive argument that either sound tax policy or demonstrated abuse of the General Utilities doctrine required the abandonment of this long-standing part of Subchapter C.

The vast majority of empirical research has been conducted on large publicly-held corporations due to availability of stock market prices, volume of market transactions, etc. See Krinksy, Rotenberg, and Thornton, "Takeovers--A Synthesis." If, as some commentators suggest, the nonrecognition provisions of the 1954 Code played a more important role for smaller closely-held corporations than for larger publicly-held corporations, it is not clear that any researcher has carefully explored the role of the General Utilities doctrine or that the repeal of this doctrine was based on any definitive empirical results.

20/See Jacobs and Schmedel, "Tax Loophole Used by Corporate Raiders In Selling Off Assets Is Closed by Congress," Wall St. J. (November 7, 1988) at B8 (stating the limitations on the use of installment reporting enacted by the Technical and Miscellaneous Revenue Act of 1988 are likely to have little effect on the number of corporate divestitures because tax considerations are generally a minor issue).

21/As discussed in Chapters III and IV of this Study, many commentators argue that the corporate level nonrecognition provisions based on the General Utilities doctrine often made a corporation more valuable from a tax perspective in the hands of an acquiring corporation than in the hands of its present owners.

22/Treasury News Release B 942 (April 9, 1987) reprinted in BNA Daily Tax Reporter No. 68 at p. J-4 (April 10, 1987).

23/See Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution," 37 Tax Notes 415 (1987) at 416.

24/Press Release from House Ways and Means Committee as reported in 42 Tax Notes 1014 (February 20, 1989).

25/See Matthews, "Subchapter C Study on Hold Until Treasury Tax Vacancy Filled," 42 Tax Notes 1426 (March 20, 1989) at 1426.

26/Id.

27/Id., at 1426.

28/See Arthur Andersen & Co., Washington Tax Letter "Gremlins Hidden in 1988 Tax Returns Likely to Rekindle Tax Reform Debate" (No. 88-2, March 1988). Arthur Andersen states:

> Numerous proposals have been developed and circulated over the years to 'reform' the tax treatment of mergers and acquisitions, but most have gained little congressional interest because they are technical in nature and never viewed as raising much revenue. Only after the Senate Finance Committee staff released its coordinated recommendations in 1985 [the Subchapter C Revision Act of 1985], and the number of leveraged transactions and hostile takeovers dramatically increased, did tax writers begin to eye these proposals with some interest. Many proposals were eventually enacted as part of the 1986 and 1987 tax legislation, but the changes were never made in the way originally envisioned by the Finance Committee staff.
>
> Now another report, this time coming from the Treasury and mandated by Congress in 1986 [the Subchapter C Study], is about to be released. The increase in mergers, leveraged buyouts and other such transactions has heightened interest in the issue, and tax committee hearings are expected on the Treasury Report.
>
> The Treasury is expected to focus on limiting the use of leveraged buyouts. Because interest is deductible and dividends are not, Treasury proposals likely will rekindle the debate over the debt-verses-equity classification issue.

29/See Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future" at 37-152.

30/See Id., at 37-150 and 37-151. Leduc and Gordon state:

The Treasury thus failed to exercise any leadership on this issue, and that failure undoubtedly made Congressional action substantially more difficult.

As a theoretical matter, the principal debate over the electivity proposal [the proposal to allow explicit electivity of corporate level tax results of a qualified acquisition regardless of the type of consideration used] focused not upon the merits of electivity or upon the effective expansion of the reorganization provisions, but upon the corollary repeal of the General Utilities doctrine. Nevertheless, had the issues been articulated, grounds for dispute were clearly present. At least three principal criticisms of the electivity regime may clearly be made. First, . . . , the blurring to the line between sales and reorganizations may itself be undesirable. . . . Second, the electivity regime may be criticized on a number of grounds. Among them are the time value principle: the future corporate tax is not the equivalent of a tax dollar today; and the realization principle: gain should be recognized when it is realized. Third, the electivity regime may be criticized on procedural grounds. Although the simplicity of electivity may be initially appealing, our experience with the elective regime of Section 338 has not been wholly favorable.

31/See Id., at 37-153. In discussing corporate distributions, the House Report on the Revenue Act of 1987 states the Ways and Means Committee:

> specifically rejects the concept that recognition [of gain] can be deferred merely because the underlying assets of the subsidiary do not obtain a stepped-up basis. This is because the potential for a corporate-level tax in the future, resulting from the low basis of the assets, is not the economic equivalent of a current tax on the appreciation [in the parent's assets] at the time of the sale or distribution.

House Comm. on the Budget Rept. on H.R. 3545, The Omnibus Budget Reconciliation Act of 1987 (Revenue Provisions), H.R. Rept. 391, 100 Cong., 1st Sess., pt 2, at 1081-1082.

32/See, e.g., Porcano, "Distributive Justice and Tax Policy," LIX Acct. Rev. 619 (1984). Because taxation is a behavioral system, Porcano argues that taxpayers' attitudes toward taxation generally and a specific tax system have a major impact on the efficacy of a specific tax system. This study, which used graduate business students and business school faculty members as surrogates for decision makers, illustrates one means by which taxpayers' attitudes can be used to make judgments about traditional tax policy objectives such as fairness, simplicity, and the conflict between these objectives. The conclusion of the study is that if taxpayers' attitudes and likely responses are explicitly considered in designing tax systems, cheating and other dysfunctional behaviors can be avoided.

The principal weakness of experimental research is limited external validity. Students may not be representative of real decision makers due to lack of experience, lack of real money, and lack of a real employment setting. The experimental task is often very artificial (e.g., a limited number of constraints and variables and interactions between the variables). See Id., at 634.

33/See Ronstadt, The Art of Case Analysis (Lord Pub. Co., 1988).

34/There are many indications that the base-broadening and tax rate reductions enacted by Congress during the Reagan administration are being imitated throughout the world. See "The Reagan Legacy," Wall St. J. (January 19, 1989) at A10 (noting the reduction in tax rates is the most important economic legacy of the Reagan administration and that many major industrialized countries are following this pattern in recent tax legislation). See also Decelles, "Tax Reform Around the World," KPMG Peat Marwick (Fall 1988) at 6 (noting that tax reform in many major industrialized countries contains base-broadening and tax rate reductions such as occurred in the United States during the Reagan administration).

35/Thomas Downey, a member of the House Ways and Means Committee, suggests that Congress could best support tax simplification efforts by not enacting any new tax legislation in the next five years. See Magnusson, "Had Enough Tax Reform?" More Is Probably On the Way," Bus. Wk. (April 25, 1988) at 62. Most commentators do not believe Congress will act in this manner. See Doernberg and McChesney, "On the Accelerating Rate and Decreasing Durability of Tax Reform," 71 Minn. L. Rev. 913 (1987).

36/See generally Minarik, Making Tax Choices (Urban Institute Press, 1985).

37/See, e.g., Bennett, "When Management Professors Gather, Relevance Sometimes Rears Its Ugly Head," Wall St. J.

(August 15, 1988) at B22 (quoting a Stanford University management professor who stated he "wasn't interested in" whether his research and findings had any real-world or practical implications).

38/Cf. Stigler, The Intellectual and the Market Place (Harvard University Press, 1984) (suggesting that in many situations, research findings have no discernable effect on public policy decisions) and Rowley, "The Legacy of Keynes: from the General Theory to Generalized Budget Deficits," in Buchanan, Rowley, and Tollison (eds.), Deficits at 163 (concluding that research efforts and results often have little influence on anyone).

39/See Watts and Zimmerman, Positive Accounting Theory (Prentice-Hall, 1986) at 12.

40/Not all commentators agree that research orientations should be categorized as positive or normative or that positive research has made the many and lasting contributions claimed by its proponents. See, e.g., Chirstenson, "The Methodology of Positive Accounting," LVIII Acct. Rev. 1 (1983).

41/See, e.g., Watts and Zimmerman, Positive Accounting Theory; Watts and Zimmerman, "Towards a Positive Theory of the Determination of Accounting Standards," 53 Acct. Rev. 112 (1978); and Watts and Zimmerman, "The Demand and Supply of Accounting Theories: The Market for Excuses," 54 Acct. Rev. 273 (1979).

42/See generally Adbel-khalik and Solomon (eds.), Research Opportunities in Auditing: The Second Decade (American Accounting Association, 1988).

43/Watts and Zimmerman observe that until the 1960s, virtually all financial accounting and auditing research was normative. This research typically described various prescriptions for various practice problems and rarely performed empirical tests of hypotheses which could have been logically deduced from these prescriptions. See Watts and Zimmerman, Positive Accounting Theory at 14.

The term "positive theory" has been used in science and in economics to describe statements of how the world works and to make it clear that positive theories have no normative components. Hypotheses or propositions deduced from positive theories describe how the world operates in specific instances and are refutable by well designed empirical tests. See Id., at 8-9. Hypotheses and propositions deduced from normative theories are assertions of one's personal opinions or values and generally cannot be refuted by empirical tests because the opinions or values often cannot be operationalized. See Id., at 7-8.

As is the case for inductive and deductive approaches, positive and normative theories are different but interrelated methods to approach a research question. Once a research question and specific hypotheses and propositions have been selected, positive researchers are mainly concerned with issues of internal and external validity and whether the statistical and other quantitative tests utilized are reliable in rejecting or not rejecting specific hypotheses and propositions. Because positive researchers intentionally avoid determining the appropriateness of the research question to be addressed and specification of the objective, normative theories and values are needed to provide a means by which the appropriateness of research questions are selected and are also needed to specify the objective. See Id., at 7-9.

Because even the most well designed and executed empirical research can disprove, but cannot prove, theories, hypotheses and propositions logically deduced from the theories, some researchers argue that positive theory and its associated research methodologies are the most efficient means of advancing knowledge by ruling out existing theories and promoting competing theories which may be better able to explain or predict how the world operates. See Id., at 12.

44/See, e.g., Moriarity and Collins (eds.), Contemporary Tax Research (Center for Economic and Management Research, University of Oklahoma, 1988) and Jones (ed.), Advances in Taxation Vol 1 1987 (JAI Press, 1987).

45/According to Watts and Zimmerman, tax policy researchers face many problems when attempting to conduct empirical tax research. For example, many studies attempt to determine whether a new tax law or proposed change in the existing law promotes equality, simplicity, or economic efficiency. Thus the objective of the study is to compare the present situation and the new situation on the basis of what is an inherently nonquantifiable objective and inherently subjective and value-laden concept. Watts and Zimmerman doubt such objectives can be sufficiently quantified to allow specific hypotheses or propositions to be empirically tested. Both the specification of the objective function and the evaluation of any findings will be inherently tied to the choice of the objective. See Id., at 8.

<u>See generally</u> Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative" (suggesting that tax policy criteria traditionally used such as horizontal and vertical equity are very difficult to quantify).

46/<u>See</u> Steiner, <u>Mergers: Motives, Effects, Policies</u> (University of Michigan Press, 1975) at 331. Steiner notes the accumulation and dissemination of knowledge gained from empirical research is often a very slow process. A similar discussion about the problems of establishing financial accounting standards with partial knowledge is contained in Gerboth, "The Conceptual Framework: Not Definitions, But Professional Values," 1 <u>Acct. Horizons</u> 1 (1987).

47/<u>See</u> Levmore, "Recharacterizations And The Nature of Theory in Corporate Tax Law."

48/<u>See, e.g.</u>, Brannon, "Tax Loopholes as Original Sin: Lessons From Tax History," 31 <u>Vill. L. Rev</u>. 1763 (1986) at 1773 (noting that much of the controversy around the <u>General Utilities</u> doctrine was really a dispute about what constitutes a realization of gain or loss at the corporate level in an acquisitive transaction or a complete liquidation).

49/Although most undergraduate accounting curricula and much of the published research treat these issues as if they are discrete, the issuance of FASB 96 and observation of practice clearly illustrates their close interrelationship.

Some authors suggest that the recent empirical research on corporate takeovers has a number of implications for accounting practice including:

1. determination of which corporation is the "acquirer" and which corporation is the target;

2. determination of the total cost paid by the acquirer to obtain control of the target;

3. determination of how the total cost paid by the acquirer for the target should be allocated to the target's assets, liabilities, and goodwill on the financial statements of the combined entity; and

4. resolution of difficult financial reporting, disclosure, and other post-transaction issues.

<u>See</u> Krinsky, Rotenberg, and Thornton, "Takeovers--A

Synthesis" at 265-273.

See generally Anthony and Dilley, "The Tax Pressure On Financial Reporting," 66 TAXES 466 (1988); Berton, "Investors, Beware the Secrets Lurking In Buy-Out Firm's Financial Reports," Wall St. J. (November 21, 1988) at A8; Briloff, "Accounting Practices and the Merger Movement," 45 Notre Dame Law. 604 (1970); Briloff, "Cannibalizing the Transcendent Margin: Reflections on Conglomeration, LBOs, Recapitalizations and Other Manifestations of Corporate Mania," 44 Fin. Analy. J. 74 (1988); Knight, Knight, and McGarth, "Double Jeopardy: The AMT And FASB 96," 167 J. Acct. 40 (1989); Pensler, "Accounting Rules Favor Foreign Bidders," Wall St. J. (March 24, 1988) at 28; Read and Bartsch, "How To Account For Acquisitions Under FASB 96," 167 J. Acct. 54 (1989); and Summa and Goodman, "Financial and tax accounting conformity further aggravated by the TRA," 18 Tax Adviser 260 (1987).

50/See generally Horwitz, The Irony of Regulatory Reform (Oxford University Press, 1989) Chapter 2 "Theories of Regulation" at 22-45 and Steiner, Mergers: Motives, Effects, Policies.

51/See, e.g., Simon, "The Budget Process and the Tax Law," 40 Tax Notes 627 (1989) (suggesting that the present excessive Congressional concern with revenue will not lead to sound tax policies) and Lustig, "The Emerging Role of the Federal Tax Law in Regulating Hostile Corporate Takeover Defenses: The New Section 5881 Excise Tax on Greenmail," 40 U. Fla. L. Rev. 789 (1988) (discussing the enactment of Sec. 5881).

52/See generally Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Works Of Caution"; Yin, "Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986," 42 Tax L. Rev. 575 (1987); Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future"; Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A State of Disequilibrium," 66 N.C.L. Rev. 839 (1988); and Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal," 65 TAXES 819 (1987).

The repeal of the 1954 corporate level nonrecognition provisions based on the General Utilities doctrine has clearly made stock acquisitions more favorable than asset acquisitions on a present value basis and has reinforced the old adage that sellers want to sell stock while buyers want to buy assets. Unger, for example, states:

> The repeal of the General Utilities doctrine will encourage parties to use stock acquisitions whenever T [target corporation] owns appreciated assets (and does not have expiring net operating loss carryovers) because only stock acquisitions will permit the parties to effect a nonrecognition of gain (coupled with a carryover basis) transaction at the T level. The repeal of the General Utilities doctrine will create problems if a stock acquisition is not possible or desirable (such as if P [acquiring corporation] does not wish to assume contingent or unknown liabilities [of T]).

Unger, "Gain Recognition and Basis in Acquisitions," 45 Inst. on Fed. Tax'n (1987) at 3-1, 3-25. Unger suggests that although the repeal of the General Utilities doctrine will encourage some acquisitions to be structured as tax-free acquisitive reorganizations, the desire of the sellers to receive cash will limit the usefulness of this technique. See Id. Unger also notes that Sec. 338 transactions could become a trap for the unwary because Congress repealed the General Utilities doctrine but did not repeal asset and stock consistency rules of Secs. 338(e) and 338(f). See Id., at 3-31 through 3-33.

53/See, e.g., AICPA Tax Division Newsletter (AICPA, Winter 1989) at 8 advertizing its newly developed continuing professional education course entitled "Saving Taxes Through Tax-Free Transactions."

Unger notes that under the 1986 Code:

> . . . purchasers and sellers will continue to focus on income tax considerations in determining whether to structure corporate acquisitions as a tax-free or taxable transaction, and whether the acquisitions should involve the purchase of [target] stock or assets.

Unger, "Gain Recognition and Basis in Acquisitions" at 3-2 and 3-3.

Unger asserts that under the 1986 Code the principal objective of the target corporation and its shareholders will continue to be to minimize the income tax liability. In the post-General Utilities world, these parties will be particularly concerned that any income arising from the acquisition will not be subject to tax at both the corporation and shareholder levels. See Id., at 3-3. The principal objective of the acquiring corporation will be to recover its full investment in the target on an after-tax basis as soon as possible. See Id., at 3-4. The acquiring corporation will therefore want (1) to take a fair market value basis in the target's depreciable assets; (2) to allocate as much of the purchase price as possible to the target's short-lived and depreciable assets; and (3) to utilize the target's net operating losses. See Id., at 3-3 and 3-4. Unger asserts that the typical tensions that existed under the 1954 Code and ways to resolve them (e.g., negotiations between the parties and manipulation of the legal form of the transactions) will continue. See Id., at 3-4.

Unger states:

> The repeal of the General Utilities doctrine reaffirms a basic principle of Federal income tax law that the rules governing gain recognition to asset transferors and asset basis step-up to purchasers operate in tandem. The application of this basic principle to sales of businesses pursuant to plans of complete liquidation is a significant departure from prior law, and it provides tax practitioners with an opportunity to be creative in structuring acquisitions. Like parents of a new child, tax practitioners planning acquisitions will find that they must be ever aware of new developments and that their creativity will be constantly tested.

Id., at 3-34 and 3-35.

The provisions of Sec. 1060 added to the Code by the TRA of 1986 are intended to conform the allocation of basis in taxable asset acquisitions and Sec. 338 transactions. See generally Auster, "Allocation of Lump-Sum Purchase Price upon the Transfer of Business Assets After Tax Reform," 65 TAXES 545 (1987); Roche, Myers, and Zucker, "Price Allocations on Acquisitions and Basis Step-Up: Tilting at Windmills?" 65 TAXES 733 (1987); and Swirksy, "Purchase Price Allocations in Taxable Asset Acquisitions, 67 TAXES 252 (1989).

Unger notes that the repeal of the General Utilities doctrine and the repeal of favorable taxation of long-term capital gains suggest that the selling and buying corporations may no longer have adverse interests and that the IRS will be more concerned with allocations of the selling price of the target by the purchasing corporation. See Unger, "Gain Recognition and Basis in Acquisitions" at 3-19 through 3-25.

Both Unger and Swirksy note that if legal or other constraints (e.g., the acquiring corporation does not want to become legally liable for the target's liabilities) force an asset sale, rather than the sale of stock generally preferred by the shareholders of the target corporation under the 1986 Code, the harsh effects of the repeal of the General Utilities doctrine and Sec. 1060 may be avoided by having the consideration paid to the target shareholders take the form of covenants not to compete and employment contracts. See Unger, "Gain Recognition and Basis" at 3-25 and Swirsky, "Purchase Price Allocations in Taxable Asset Acquisitions" at 256.

In a comment that demonstrates the continued elevation of legal form over economic substance for acquisitive transactions and the resulting lack of predictability, Swirsky notes:

> Creative and aggressive lawyers and accountants are reaching for new opportunities to assign values to items that can provide significant future income tax benefits [to the acquiring corporation]. It is likely, however, that the IRS will more closely scrutinize transactions involving these types of components.

Id., at 258.

54/See generally Simon and Simmons, "The Future Of Section 355," 40 Tax Notes 291 (July 18, 1988) and Friedman, "Spin-offs, split-offs and split-ups remain favored despite the Tax Reform Act of 1986," 15 Tax'n for Law. 348 (1987).

55/See generally Stiglitz and Wolfson, "Taxation, Information, and Economic Organization," 9 J. Am. Tax'n A. 7 (1988). Stiglitz and Wolfson note that systematic attempts to understand and explore the various aspects of taxation, particularly the information economics aspects, are a relatively recent event.

Endnotes--Appendix A

1/38 Stat. 172.

2/29 Stat. 756.

3/39 Stat. 1000.

4/Westin describes the origins of the tax-free reorganization definitions and operating provisions as "remarkably terse and unilluminating." Westin, "In Like A Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse" at 1002. In summarizing the historical development of the tax-free reorganization provisions, Westin states:

> . . . the history of the reorganization provisions has been one of continuing expansion and classification, but throughout, two themes have sounded:
>
> 1. The reorganization is not an appropriate time for imposing a tax, as "nothing happened." That is, the change [in corporate structure and in the property interests held by the shareholders and security holders of the target corporation] is formal only.
>
> 2. Business organizations should not be troubled by tax considerations in undergoing restructurings which are prompted by business exigencies.

Id.

5/Sec. II(A)(Subdivision 1) of the Revenue Act of 1913 provided that an income tax would be levied, assessed, collected, and paid annually upon the entire net income arising or accruing from all sources. 38 Stat. 166. This all-inclusive definition of gross income is reflected in Sec. 61(a) of the 1986 Code (gross income includes income from all sources except for statutory exclusions). Regs. 1.368-1(b) notes that Sec. 61 provides a general rule that gain or loss realized upon the exchange of property must be immediately recognized if the property received differs in a material particular, either in kind or in extent, from the property given up. Regs. 1.368-1(b) states that the purpose of the tax-free reorganization provisions is to exempt from the general recognition rule of Sec. 61 certain "specifically described" exchanges incident to such readjustments of corporate structures made in one of the ways specified in the Code as are required by business exigencies and which effect only a readjustment of continuing interests in property under modified corporate forms. As discussed in the text supra, most commentators agree that the courts created the judicial doctrines because the literal language of the early reorganization provisions did not fully define or limit the scope of term "reorganization." See, e.g., Sandberg, "The Income Tax Subsidy to 'Reorganizations'".

6/Decisions of the United States Supreme Court are very important for tax compliance and tax planning purposes. In Rev. Rul. 80-60, 1080-1 CB 97, the Internal Revenue Service stated that its actions are bound by Supreme Court decisions.

7/257 U.S. 156 (1921). Holzman regards this decision as the original triumph of form over substance in the tax-free reorganization area. See Holzman, Corporate Reorganizations at 2-6.

8/257 U.S. 176 (1921).

9/262 U.S. 134 (1923).

10/265 U.S. 242 (1924).

11/268 U.S. 536 (1925).

12/Many of the early decisions which influenced Congress in enacting the original statutory definitions and operating provisions for corporate reorganizations are discussed in Andrews, Federal Income Taxation of Corporate Transactions at 38-53 and at 65-152. Andrews also states:

> In applying the early reorganization statutes the courts announced doctrines and requirements that have been a lasting part of the law. Indeed these doctrines have sometimes seemed to be a more permanent part of the law than the statute whose interpretation brought them forth.

Id., at 65.

Posin notes the early decisions are "unsettling" because the outcomes seem to depend not on predictable extensions of precedents, but instead on a power struggle between the BrandeisPitney wing and the McReynolds wing of the

United States Supreme Court. See Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web," at 1347.

Bittker and Eustice state:

> Faced by such a rudimentary statute, the courts not surprisingly felt called upon to protect the 'spirit' of the legislation against its 'letter' by segmenting 'sales' and disguished 'dividends' from true reorganizations. . . . The rudimentary provisions that first evoked the protective instincts of the courts have been revisited many times in the intervening years, and in some areas, have taken over the watchdog functions of the courts. But Congress has never ousted the courts of this jurisdiction, so that the sophisticated reorganization provisions of the 1954 Code have not outgrown the judicial restrictions that were imposed in their childhood.

Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders at 14-11.

In commenting on the origin of necessity for the judicial doctrines which soon came to serve as prerequisites for the often desired tax-free reorganization treatment, Westin states:

> From the early days, the Federal courts have striven to assure that the lofty purposes of the reorganization exception [to the general rule that all realized gains should be immediately recognized] were not manipulated to convert [taxable] sales into tax-exempt transactions. The continuity of enterprise, business purpose, and proprietary of interest doctrines all reflect that concern, and were required to keep the reorganization exception from becoming a fiscal truck hole.

Westin, "In Like A Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse" at 1003.

13/Due to the lack of a special nonrecognition rule (and related basis rules) applicable to the gain realized by the shareholders and security holders in the early refinancing cases, the courts held that all realized gain must be immediately recognized even though the shareholders and security holders held a continuing interest in the corporation involved and received no cash or other boot. Congress seemed particularly concerned that tax laws which taxed realized gains when no cash or other boot was received (i.e., so-called "paper gains") was not appropriate. Sandberg notes that the most plausible explanation for the enactment of the initial nonrecognition rules for tax-free reorganizations in the Revenue Act of 1918 is that only cash receipts are "income" and that tax laws which only impose a tax when cash or other liquid assets (i.e., boot) are received are more easily implemented and administered than alternative tax laws. <u>See</u> Sandberg, "The Income Tax Subsidy to 'Reorganizations'" at 100.

The tax literature is virtually unanimous in concluding that many of the present problems associated with today's tax law for acquisitive transactions can be traced back to what Holzman has described as confused approach to drafting the early tax-free reorganization provisions and attempting to distinguish taxable sales and tax-free reorganizations. Holzman notes:

> At first, Congress was admittedly groping for a method of presentation of an idea. Perhaps 'at first' is an improper phrase to use, because every revenue act since 1918 has changed the concept somewhat. The reorganization sections, because they involve an exception to the general rule that transfer or exchanges beget taxable income or deductible loss, are based on the principles of equity or law in the purest sense.

Holzman, <u>Corporate Reorganizations</u> at 2-1. <u>See generally</u> Shurtz, "A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative," 31 <u>Vill. L. Rev</u>. 1665 (1986) and Brannon, "Loopholes As Original Sin: Lessons From Tax History," 31 <u>Vill. L. Rev</u>. 1763 (1986).

Both Westin and Faber agree that the only creditable rationale for the continuation and expansion of the tax-free reorganization provisions since the Revenue Act of 1918 is economic (i.e., to not impede changes in business form) rather than fiscal. <u>See</u> Westin, "In Like A Lion And Out Like A Lamb: The 98th Congress And The Liquidation-Reincorporation Abuse" at 1003 and Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 292-295.

14/Andrews describes the early statutory provisions, particularly those contained in the Revenue Act of 1928, which provide the basis for many of the definitional and operative provisions contained in the 1954 and 1986 Codes as "primitive." Andrews, Federal Taxation of Corporate Transactions at 1-63. Bittker and Eustice state "the reorganization provisions of the 1954 Code are the progeny of surprising primitive ancestors." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders at 14-10.

Holzman and other commentators note that once Congress decided to enact some type of tax-free (and what by the Revenue Act of 1924 became the basis of today's tax-deferred) provisions for reorganization transactions, two distinct schools of thought became evident on how the legislation should be drafted. Holzman states:

> One group wanted to provide, legislatively, for every possible type of transaction, so that the prospective transaction could be shaped to fit a ready-made model. The other group preferred to set general principles, which could be applied to each type of venture as it was presented. The latter group seems to have prevailed, and it is difficult to see how the first thought could have produced a satisfactory result.
>
> With the tremendously large number of possible types of reorganizations as to variety even today, every situation could not have been predicted and ruled upon in advance. Consequently, general reorganization provisions were set up.

Holzman, Corporate Reorganizations at 2-2.

The tax literature is not unanimous in concluding the lack of a statutory definition of a "reorganization" and the lack of clear parameters around the term "reorganization" account for creation of the judicial doctrines and much of the resulting uncertainty and complexity of the current tax law. Cf. Ferrero, "Continuity of Interest Revisited" at 44-1 through 44-4 (arguing that the lack of parameters "naturally" caused the Internal Revenue Service and the courts to attempt to protect the tax-free reorganization provisions from tax abuse) and Sandberg, "The Income Tax Subsidy To 'Reorganizations'" at 125 (arguing that the tax-free reorganization provisions contained in the Revenue Act of 1934 are too specific and complex, have not enhanced certainty and predictability, and have done much to tie the hands of the courts in dealing with elaborate tax-avoidance schemes).

In commenting on the Revenue Act of 1924, Posin notes:

> The 1924 statute is a remarkable accomplishment in its comprehensiveness and detail. It set down much of the language and many of the principles that currently govern the treatment of reorganizations.
>
> The great detail of the 1924 Act marked a triumph in the Treasury Department of the approach advocated by A. W. Gregg, Special Assistant to the Secretary of the Treasury, who believed that a comprehensive statutory approach was warranted. The competing approach, advocated by Dr. Thomas Adams, was that the statute should express general principles and leave it to the Treasury Department to develop specific regulations dealing with individual cases. Not surprisingly, the Treasury Department came to support Dr. Adams's view. Congress, however, adopted the Gregg approach.

Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web" at 1349-1350.

15/The various tax deductions, credits, exclusions, and deferred recognition provisions contained in the Internal Revenue Code can be evaluated as tax expenditure provisions. Steuerle concludes that the budget processes within the executive branch and the Congress are not designed to encourage careful and thoughtful examination of tax expenditure programs in the Code. <u>See</u> Steuerle, <u>Who Should Pay For Collecting Taxes? Financing the IRS</u> at 39-37.

In commenting on the continued use of tax expenditure programs in the Code wihtout a reliable means of evaluating them, Steuerle states:

> Imagine again some private business spending millions or billions of dollars and not accounting for the total amount of the expense!

<u>Id</u>., at 40.

For a discussion of tax expenditures and the federal budget process see Simon, "The Budget Process And The Tax Law"; "Special Analysis G: The Fiscal 1990 Tax Expenditures Budget"; The Condition of the Tax Legislative Process," 39 Tax Notes 1581 (June 27, 1988); and Verdier, "A Framework For Predicting Congressional Action," 41 Tax Notes 435 (October 24, 1988).

16/As expected, businessmen and their advisers attempted to persuade Congress that to impose a tax on the increment in value of corporate assets or corporate stock whenever "necessary business adjustments" were made did not represent sound tax or economic policy. Sandberg notes that the "interference with business" argument "was the practical voice of business men who did not want income taxes to hinder the era of expansion and concentrations which, in the early 'twenties, loomed just ahead." Sandberg, "The Income Tax Subsidy To 'Reorganizations'" at 99.

Posin suggests "high income tax rates are the mother of tax invention." Posin, "Taxing Corporate Acquisitions: Purging Penelope's Web" at 1341. Instead of concerns with tax policy or other conceptual issues, both Posin and Sandberg conclude that the very high marginal tax rates contained in the Revenue Act of 1917 and the desire not to dampen the anticipated economic expansion of the United States in 1918-1920 were primarily responsible for Congressional and Treasury Department interest in enacting some type of tax-free (i.e., tax-deferred) reorganization provisions.

Sandberg is troubled by the argument that Congress should provide favorable tax results for reorganizations because they involve "only" legal or technical changes in corporate structures and ownership interests rather than substantive changes which are the proper basis for taxation. Sandberg states this conceptual explanation is not even verbally plausible (emphasis in the original). Sandberg, "The Income Tax Subsidy To 'Reorganizations'" at 100.

17/40 Stat. 1060.

18/S. Rep. No. 617, 65th Cong., 3rd Sess. (1918) at 5.

19/Congress did not specifically state a continuity of proprietary interest requirement at the target shareholder level or a continuity of business enterprise requirement at the acquiring corporation level as a prerequisite to the overall transaction constituting a tax-free reorganization. Congress apparently assumed that a merger, consolidation, or other type of "reorganization" would routinely be effected by the issuance of acquiring corporation stock and that the acquiring corporation would continue the target's business(es). _See_ Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 240.

20/Ferrero, "Continuity of Interest Revisited" at 44-3.

21/42 Stat. 230.

22/S. Rept. No. 275, 67th Cong., 1st Sess. (1921) at 11-12 and H. Rept. No. 350, 67th Cong., 1st Sess. (1921) at 10.

23/_See_ Brookes, "The Continuity of Interest Test in Reorganizations--A Blessing or a Curse?" 34 _Calif. L. Rev_. 1 (1946) and Turnier, "Continuity of Interest--Its Application to Shareholder of the Acquiring Corporation," 64 _Calif. L. Rev_. 902 (1976).

24/Holzman, _Corporate Reorganizations_ at 2-6.

25/Regs. 62 at Article 1566(b).

26/Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web" at 1349. Testimony before Congressional committees indicates that the federal government lost a significant amount of revenue due to the absence of the now familiar carryover and a substituted basis rule for reorganizations. _See_ H.R. Rept. No. 179, 68th Cong., 1st Sess. (1924) at 7-13.

27/43 Stat. 257.

28/_See_ Holzman, _Corporate Reorganizations_ at 2-11 and _Mead Coal Co. v. Comm_., 72 F.2d 22 (4th Cir. 1934).

29/H.R. Rept. No. 179, 68th Cong., 1st Sess. (1924) at 13 and S. Rept. No. 398, 68th Cong., 1st Sess. (1924) at 14. Congress also stressed the importance of taxpayers being able "to determine prior to the consummation of a given transaction the tax liability that will result therefrom." H.R. No. 179, 68th Cong., 1st Sess. (1924) at 13.

30/_See_ H.R. Rept. No. 179, 68th Cong., 1st Sess. (1924) and Posin, "Taxing Corporate Reorganiations: Purging Penelope's Web" at 1349.

31/_See_ n. 14 _supra_.

32/Davis, _Corporate Acquisitions and Dispositions of_

<u>Businesses</u> (Mark A. Stephens, Ltd., 1974) at 4-1.

33/Holzman, <u>Corporate Reorganizations</u> at 2-11.

34/Under Sec. 203(h)(1) of the Revenue Act of 1924, "reorganizations" included what are defined in Sec. 368(a)(1) of the 1986 Code as statutory mergers and consolidations, "B" reorganizations, "C" reorganizations, nondivisive "D" reorganizations, "E" reorganizations, and "F" reorganizations.

35/Sec. 203(h)(2) of the Revenue Act of 1924 defined the term "a party to the reorganization" in much the same manner as Sec. 368(b) of the 1986 Code. Sec. 203(h)(2)(i) defined the term "control" in much the same manner as Sec. 368(c) of the 1986 Code. Secs. 203(b) and 203(d) provided much the same shareholder/security level nonrecognition rules as contained in Secs. 354 and 356 of the 1986 Code (realized gain is recognized to the extent of boot received). Sec. 203(f) provided that a shareholder/security holder cannot recognize a loss even if a loss is realized and if boot is received. Sec. 356(c)(2) of the 1986 Code provides the same result. Sec. 203(d)(2) provides similar characterization rules as contained in Sec. 356(a)(2) of the 1986 Code. Gain recognized by the shareholders of the target corporation is a dividend if the distribution(s) "had the effect of the distribution of a taxable dividend" and if the distributing corporation had sufficient earnings and profits. The remainder of any recognized gain is treated as arising from the sale of the target corporation stock. Sec. 204(a)(6) provided essentially the same shareholder level substituted basis rules as Sec. 358 of the 1986 Code. Sec. 204(a)(7) provided essentially the same corporate level carryover basis rules as Sec. 362 of the 1986 Code. Sec. 203(b)(3) provided that the target corporation will not recognize gain even if it is realized. Sec. 361 of the 1986 Code provides much the same result.

36/In comparing the Revenue Act of 1924 and the Revenue Act of 1934, the major difference is in the statutory definition of transactions accorded reorganization status. <u>Compare</u> Sec. 203(h)(1) of the Revenue Act of 1924 and Sec. 112(h)(1) of the Revenue Act of 1934. The operative provisions are quite similar. <u>Compare</u> Secs. 203(b)(2), 203(b)(3), 203(c), 203(d)(1), 203(d)92), 203(e)(1), 203 (e)(2), and 203(g) of the Revenue Act of 1924 and Secs. 112(b)(3), 112(b)(4), 112(c)(1), 112(c)(2), 112(d)(1), 112(d)(2), and 112(e) of the Revenue Act of 1934.

37/44 Stat. 12.

38/45 Stat. 817.

39/Sec. 368(a)(2)(D) was added to the 1954 Code in Pub. L. No. 90-621, 82 Stat. 1310 (1968) and was effective with respect to statutory mergers occurring after October 22, 1968. The committee reports indicate that Congress enacted Sec. 368(a)(2)(D) for the following reasons: (1) To allow parent stock to be used in triangular mergers (sometimes referred to as forward triangular mergers), particularly those in which an operating target corporation is merged into an operating subsidiary corporation in exchange for stock of the controlling (parent) corporation. (2) To provide a mechanism by which this type of transaction can be effected where the parent corporation, for business or legal reasons, does not want to hold (even temporarily) the assets of the target corporation. (3) To remove an inconsistency in the law which allowed the use of parent corporation stock as consideration in triangular (subsidiary) "B" and "C" reorganizations but not in triangular "A" reorganizations. See S. Rept. No. 1653, 90th Cong., 2nd Sess. (1968).

A triangular or subsidiary merger allows the acquiring corporation to use a newly formed or existing controlled subsidiary to acquire the target. Under current law, a triangular merger (of the target into the controlled subsidiary) can constitute a tax-free reorganization under the following circumstances: (1) The parent corporation issues its stock in exchange for substantially all of the properties of the target corporation. (2) The controlled (subsidiary) corporation does not use any of its stock as consideration for the properties acquired from the target. (3) The merger of the target corporation into the controlled corporation would have satisfied all of the other statutory and judicial requirements of a tax-free "A" reorganization if the target had been merged directly into the parent (controlling) corporation. See Secs. 368(a)(1)(A) and 368(a)(2)(D).

In many states, a statutory merger of the target into the acquiring corporation will cause the acquiring corporation to assume responsibility for all liabilities of the target. The triangular merger technique of Sec. 368(a)(2)(D) is used primarily to allow the parent corporation to acquire the properties of the target corporation while protecting the parent corporation from exposure to the known, contingent, and unknown liabilities of the target. See generally Ferguson and Ginsburg, "Triangular Reorganizations," 28 Tax L. Rev. 159 (1973); Testa, "The 'A,' 'B,' 'C,' Matrix of Triangular Reorganizations"; and Schlenger, "Triangular Acquisitions," 40 Inst. on Fed. Tax'n (1982) at 49-1.

40/Sec. 368(a)(2)(E) was added to the 1954 Code in Pub. L. No. 91-693, 84 Stat. 2077 (1971) and was effective with respect to statutory mergers occurring after December 31, 1970. The committee reports indicate Congress enacted Sec. 368(a)(2)(E) for the following reasons: (1) To remove an inconsistency in the law created by the enactment of Sec. 368(a)(2)(D) in 1968. Sec. 368(a)(2)(D) allowed a target to be merged into a controlled subsidiary of the parent for parent stock but the law did not allow a merger in the opposite direction, i.e., of the controlled subsidiary into the target corporation for parent stock. (2) To recognize there are often sound business and legal reasons for such reverse triangular mergers (such as preserving the existence of the target) which are wholly unrelated to income taxes. (3) To allow more flexibility in terms of consideration used than is ordinarily possible in a "B" reorganization. See H.R. Rept. No. 91-1778, 91st Cong., 2nd Sess. (1980) and S. Rept. No. 91-1553, 91st Cong., 2nd Sess. (1980).

A reverse triangular merger allows a parent corporation to merge a newly created or existing controlled subsidiary into a target corporation, thus preserving the corporate existence of the target. In general, a reverse triangular merger is used as an alternative to a "B" reorganization when the continued existence of the target corporation is to be maintained and the solely for voting stock requirement of Sec. 368(a)(1)(B) cannot be satisfied.

Under current law, a reverse triangular merger (of a controlled subsidiary into the target) can constitute a tax-free "A" reorganization under the following circumstances: (1) The parent (controlling) corporation causes its subsidiary to merge into the target corporation. (2) The controlled subsidiary corporation transfers substantially all of its properties as well as parent corporation stock to the target corporation. (3) After the exchanges of stock, the target (surviving) corporation holds substantially all of its properties and substantially all of the properties of the subsidiary corporation which merged into the target, other than the stock of the parent corporation which is distributed to the shareholders of the surviving corporation in the transaction. (4) In the transaction, the former shareholders of the target corporation exchange, for an amount of voting stock of the parent corporation, an amount of target stock which constitutes control of the target corporation. See Secs. 368(a)(1)(A) and 368(a)(2)(E). See generally Willens, "Flexibility of Reverse Mergers Increased by Regs. and Rulings," 70 J. Tax'n 521 (1989).

41/The Tax Reform Act of 1986 makes it clear that Sec. 336(a) of the 1986 Code (which provides a general rule that liquidating in-kind distributions of appreciated property are treated as a sale of the property by the distributing corporation) does not apply to any distribution of property to the extent that the recipient does not recognize gain under Secs. 351 through 368 of the 1986 Code. The interaction between the complete liquidation and tax-free reorganization rules of the 1986 Code are discussed in Brandt and Maloney, "Reorganization instead of liquidation may accomplish same result with much less tax," 34 Tax'n for Acct. 388 (1987). Sec. 336 of the 1986 Code is discussed in Billings, Messer and Englebrecht, "Tax Planning for Complete Liquidations: Avoiding the Impact of the TRA," 19 Tax Adviser 5 (1988).

42/48 Stat. 703.

43/43 Stat. 1648.

44/50 Stat. 813.

45/53 Stat. (Part 1) 1-504.

46/Compare Sec. 112(g)(1) of the Revenue Act of 1934 and Sec. 112(g)(1) of the 1939 Code.

47/Compare Sec. 112(g)(2) of the Revenue Act of 1934 and Sec. 112(g)(2) of the 1939 Code.

48/Compare Sec. 112(h) of the Revenue Act of 1934 and Sec. 112(h) of the 1939 Code.

49/Compare Secs. 112(b)(3), 112(c)(1), 112(c)(2), and 112(e) of the Revenue Act of 1934 and Secs. 112(g)(3), 112(c)(1), 112(c)(2), and 112(e) of the 1939 Code.

50/Compare Secs. 112(b)(4) and 112(d) of the Revenue Act of 1934 and Secs. 112(b)(4) and 112(d) of the 1939 Code.

51/68A Stat. 1.

52/See generally Flinn and Davis, "Twelve-Month Liquidations of S Corporations--Careful Planning Required Under TRA Transitional Rules," 18 Tax Adviser 674 (1987).

53/See generally Cohen, Silverman, Surrey, Tarleau and Warren, "The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations," 68 Harv. L. Rev. 393 (1955). Mertens states:

> The 1954 Code made no fundamental changes or additions either with respect to those excepted exchanges as to which the general rule of recognition of gain or loss does not apply, or with respect to the transactions which qualify as reorganizations.

Mertens Law of Federal Income Taxation (1981 Rev. Ed.) at 59.

Mertens also states:

> While the nonstatutory or judicial changes in the concept of a reorganization for tax purposes have been by far the most sweeping and decisive, the statutory changes have not been without significance. Because of such changes, extreme care must be taken in considering any reorganization problem, including related basis provisions to determine what act applies and what its particular statutory definition of a reorganization is. In the early acts, there was little or nothing in the way of statutory explanation of the details under the 1928 and the 1934 Revenue Acts. Since then there has been a period of contracting definition or simplification. Some changes of a liberalizing nature were made by the 1954 Code, but none were of major proportions.

Id., at 357.

54/Compare Sec. 112(g)(1)(B) of the 1939 Code and Sec. 368(a)(1)(B) of the 1954 Code.

55/See Secs. 368(a)(1)(C) and Sec. 368(a)(2)(B) of the 1954 Code. The operation of the boot-relaxation rule is discussed in Dailey, "The Voting Stock Requirements of B and C Reorganizations," 26 Tax L. Rev. 725 (1971). The current status of C reorganizations is discussed in Flinn, "C Reorganizations Under The Internal Revenue Code of 1986: Is More Tax Reform Needed?"

56/See Sec. 368(b) of the 1954 Code. The enactment of

Section 368(b) represented a Congressional veto of two famous Supreme Court decisions in the tax-free reorganization area: Groman v. Comm., 302 U.S. 82 (1937) and Helvering v. Bashford, 302 U.S. 454 (1938). These two decisions had severely limited the use of "triangular" reorganizations because the parent corporation of the acquiring (subsidiary) corporation was not considered "a party to the reorganization." The receipt of parent corporation stock by the shareholders of the target corporation was thus received in a taxable transaction, rather than in a transaction qualifying as a tax-free reorganization. As discussed, supra, the enactment of Secs. 368(a)(2)(D) and 368(a)(2)(E) specifically sanctioned the use of parent corporation stock in triangular and reverse triangular "A" reorganizations.

57/See Secs. 354(a)(2), 355(a)(3), and 356(d) of the 1954 Code.

58/See, e.g., Bloom and Calvert, "Corporate Changes Wrought by the Tax Reform Act of 1984," 11 J. Corp. Tax'n 299 (1985); Bonovitz, "Taxable Dispositions Of a Corporate Business Before and After TEFRA," 60 TAXES 812 (1982); Bonovitz, "Taxable Dispositions Of a Corporate Business Before and After TEFRA," 61 TAXES 325 (1983); DeLeo and Moore, "Application of Section 338 to the Purchase of Corporation Partner After the Tax Reform Act of 1984," 13 J. Corp. Tax'n 99 (1986); Faber, "The Search for Consistency in Corporate Acquisitions"; Ferguson and Stiver, "Taxable Corporate Acquisitions After TEFRA," 42 Inst. on Fed. Tax'n (1984) at 12-1; Rosenbloom, "The Effects of TEFRA Upon Mergers and Acquisitions," 41 Inst. on Fed. Tax'n (1983) at 51B-1; Taylor, "Developments in Corporate Acquisitions and Leveraged Buyouts," 43 Inst. on Fed. Tax'n (1985) at 1-1; and Walter, "Unwanted Assets in Taxable and Tax-Free Corporate Acquisitions: Old Wine in New Bottles," 63 TAXES 897 (1985).

59/See, e.g., Simmons, "The Tax Reform Act of 1986: An Overview," 1 B.Y.U.L. Rev. 151 (1987) and Hopkins and Cassil, "The TRA and Small Business: Will the Benefits Outweigh the Costs?" 18 Tax Adviser 713 (1987).

60/These changes are discussed in Gardner and Stewart, "Capital Gains and Losses After the Tax Reform Act of 1986," 65 TAXES 125 (1987) and Faber, "Capital Gains v. Dividends: Is The Battle Still Worth Fighting?" 64 TAXES 865 (1986).

61/The fact that the Tax Reform Act of 1986 made the maximum marginal corporate rate higher than the maximum marginal individual rate has made operating smaller and closely-held corporations as S corporations more attractive than under the 1954 Code. See, e.g., Ackerman, "Benefits of S Corporation Election for Closely Held Corporations Under the Tax Reform Act of 1986," 65 TAXES 372 (1987); Connors and Kozub, "Multistate S Corporations Endure Maze of State Laws," 70 J. Tax'n 174 (1989); Elfman, "Anomalies Present in Dispositions of or Acquisitions With S Corporations: Confusion of Corporate and Individual Taxes," 46 Inst. on Fed. Tax'n (1988) at 15-1; Frankel, "Choice of Entity Decisions After the Tax Reform Act of 1986," 46 Inst. on Fed. Tax'n (1988) at 45-1; Metzger, "Advantages and Pitfalls of Electing S Corporation Status for Personal Service Corporations," LIX CPA J. 30 (1989); Starr and Hillier, "Operating in the S Corporation Form: Some Practical Considerations," 46 Inst. on Fed. Tax'n (1988) at 13-1; Thompson, "Converting From S to C and From C to S," 46 Inst. on Fed. Tax'n (1988) at 14-1; Volpi, "S Corporations Before and After the TRA," 18 Tax Adviser 365 (1987); and Wiesner, "S Corporation Basis, At Risk, and Passive Loss Limitations After Tax Reform," 46 Inst. on Fed. Tax'n (1988) at 12-1. Tax planning for S corporations under the 1986 Code is discussed in Krane and Gallagher, "Preserving Subchapter S Status in Partnership Arrangements And Acquisition Transactions," 65 TAXES 862 (1987).

Some commentators suggest that electing S corporation status for smaller and closely-held corporations will be the rule, rather than the exception, if the tax rates enacted by the TRA of 1986 remain in force. See, e.g., Tannenbaum, "The Business Entity: C Corp. v. S Corp. v. Partnership," 45 Inst. on Fed. Tax'n (1987) at 6-1 and Magette and Rohman, "Choice of Business Entity After the Tax Reform Act of 1986: The Brave New World," 12 Rev. Tax'n Individuals 38 (1988).

62/See Posin, "Treatment Of The Participants In A Reorganization: Policy After The 1986 Act," 40 Sw.L.J. 1169 (1987).

63/These issues are discussed in Freeman, "Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsman of the Repeal of General

Utilities," 64 TAXES 962 (1986); Friedrich, "The Unincorporation of America?" 4 J. Corp. Tax'n 3 (1987); Levun, "Partnerships--The Preferred Form Of Doing Business After The Tax Reform Act of 1986," 65 TAXES 600 (1987); and Breen and Blackburn, "Using the S election to mitigate new gain recognition provision in Tax Reform Act," 15 Tax'n for Law. 328 (1987).

64/With the exception of the transitional relief rules contained in the TRA of 1986, the 1986 Code does not continue the favorable complete liquidation and Sec. 338 provisions of the 1954 Code. The transitional rules are discussed and illustrated in Flinn, "Taking Advantage of the Transitional Rules for Complete Liquidations of C and S Corporations Requires Immediate Planning," 65 TAXES 491 (1987).

The complete liquidation provisions of the 1954 Code are discussed in Flinn and Fulks, "Complete Liquidations of S Corporations: New Planning Required Under the Subchapter S Revision Act of 1982--Part II," S Corporations: Tax Choices for Business Planning (Prentice-Hall Loose-Leaf Tax Service) at 1319-1345; Look, "One-month liquidation can save taxes when corporation has little or no E&P," 31 Tax'n for Acct. 20 (1983); Ives, "Effective 12-month Liquidations Must Overcome Various Problems Hidden in 'Straightforward' Rules," 32 Tax'n for Acct. 362 (1984); Weintraub and Braun, "Four Types of Liquidations Provide Different Tax Results to Corporations and Shareholders," 33 Tax'n for Acct. 366 (1984); and Sugarman and Halpern, "A Checklist For Planning a Section 337 Liquidation," 19 Prac. Acct. 18 (1986).

The effects of the repeal of the General Utilities doctrine and the outright repeal of Secs. 333, and the effective repeal of Secs. 336, 337, and 338 of the 1954 Code are discussed in Bonovitz, "Impact of TRA Repeal of General Utilities," 65 J. Tax'n 388 (1986); Owen, "Something Old, Something New: Dealing With The Gaps and Traps of the General Utilities Transitional Rules," 15 J. Corp. Tax'n 37 (1988).

65/See, e.g., Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics Not Being Basic"; Lobenhofer, "The Repeal of General Utilities For Corporate Liquidations--The Consequences Of Incomplete And Unexpected Tax Reform,"; Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal"; and Zolt, "Corporate Taxation After The Tax Reform Act of 1986: A

State Of Disequilibrium."

66/Not all commentators agreed with the repeal of the General Utilities doctrine. See, e.g., Beck, "Distributions In-Kind In Corporate Liquidation: Defense of General Utilities, 37 Tax Law. 641 (1984) and Nolan, "Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine Measures," 22 San Diego L. Rev. 95 (1985).

67/Due to the pass-through nature of taxation of S corporations, particularly the fact that the shareholders of the S corporation will receive an increase in the basis of their stock for gains recognized at the corporate level, even if no corporate level tax is paid, the repeal of the complete liquidation provisions contained in the 1954 Code will not increase the tax costs of complete liquidation nearly as much as is the case for C corporations. Note that under Sec. 1374 of the 1986 Code, a corporation making a post-December 31, 1986, S election will pay a corporate level tax, computed at the highest marginal tax rates, on any built-in gains, i.e. gains which economically accrued prior to the date of the S election. The explicit Congressional purpose for the addition of Sec. 1374 was to prevent C corporations from avoiding the effect of the repeal of the General Utilities doctrine by electing S status immediately prior to a complete liquidation. The built-in gains tax, and related tax planning issues, are discussed in Kramer and Kramer, "New Section 1374 Tax Reduces The Attractiveness of an S Corporation Election for Closely Held Corporations," 65 TAXES 653 (1987) and Kristan, "Planning Around the Built-In Gains Tax," 18 Tax Adviser 865 (1987).

68/The actual or effective repeal of the corporate level nonrecognition provisions for complete liquidations and Sec. 338 transactions has made carryover basis transactions (i.e., purchases of corporation stock and tax-free reorganizations) much more attractive than taxable transactions (i.e., nonreorganization acquisitions of the target's assets and Sec. 338 transactions) under the 1986 Code on a present value basis. The repeal of the nonrecognition provisions based on the General Utilities doctrine achieved the Congressional objective of allowing the acquiring corporation to take a stepped-up basis in the assets of the target corporation only if the target corporation recognizes all gain realized but has effectively reversed the relative values of carryover basis and taxable transactions on a present value basis.

Unless the target corporation has net operating losses which can be used to offset the gain recognized in a taxable acquisition, the present value of the immediate tax cost to the target will exceed the present value of the future tax benefits if the acquiring corporation can take a stepped-up (fair market value) basis in the target's assets. Bittker and Eustice note the reduced importance of Sec. 338 is ironic because the TRA of 1986 was enacted less than a year after the issuance of voluminous and very complex regulations explaining the operation of Sec. 338, particularly the consistency rules. Bittker and Eustice note that the repeal of the General Utilities doctrine made these "temporary" regulations almost dead on arrival. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (Warren, Gorham & Lamont, Inc. Fifth Student Ed., 1987) at 11-63 and 11-64.

As a general rule, many acquisitive transactions will be structured as acquisitions of the target's stock instead of acquisitions of the target's assets under the 1986 Code. The principal reason is that an acquiring corporation's acquisition of target stock is not, absent a Sec. 338 election, treated as the acquisition of the underlying assets of the target and thus is not a realization event at the target corporation level. The taxable acquisition of target's assets will generally result in the recognition of all gain realized by the target corporation and the recognition of all gain realized by the target shareholders if the target is completely liquidated as part of the acquisition or distributes the proceeds to its shareholders. Even if the target corporation does not completely liquidate or distribute the sale proceeds to its shareholders, the present value of the immediate tax cost to the target corporation will generally exceed the present value of the tax savings to the acquiring corporation from the fair market value basis it will obtain for the target's assets in a taxable acquisition.

These issues are discussed in Brode, Tax Planning For Corporate Acquisitions (Prentice Hall/Rosenfeld Launer Publications, 1988); Mullaney and Bailine, "Corporate acquisitions after the Tax Reform Act of 1986"; and Maloney and Brandt, "Taxable and Nontaxable Acquisitive Techniques: A Case of the Basics not Being Basic."

In Congressional testimony on the acquisition proposals, many commentators opposed the repeal of the long-standing corporate level nonrecognition provisions based on the

<u>General Utilities</u> doctrine. Byrle Abbin, of Arthur Andersen, testified that the repeal of these nonrecognition provisions constituted an unwarranted and major expansion of the double tax system for C corporations. Abbin also testified that in spite of the alleged objective of making the tax law more economically efficient, the repeal of the <u>General Utilities</u> doctrine will create significant economic disincentives for taxable corporate acquisitions because the acquiring corporation will rarely, if ever, be able to obtain a tax basis in the target's assets equal to the cost of its investment and because the present value of the future tax benefits to the acquiring corporation from a taxable transaction will rarely, if ever, exceed the present value of the immediate tax cost to the target corporation. Because acquiring corporations often evaluate corporate acquisitions using the present value of the after-tax return on investment, the repeal of the <u>General Utilities</u> doctrine will reduce the value of the assets or of the stock of many target corporations because an acquiring corporation will not consummate the acquisition if it cannot achieve its desired after-tax return. <u>See</u> 1983 Hearings on Reform of Reform of Corporate Taxation at 382-388.

69/<u>See generally</u> Zimbler, "The Corporate Alternative Minimum Tax: Another Look," 65 <u>TAXES</u> 846 (1987).

70/Arguments as to why small businesses should have been permanently exempted from the repeal of the <u>General Utilities</u> doctrine are discussed in Poffenbarger, "<u>General Utilities</u> Repealed: Why Small Businesses Should Be Excepted," 65 <u>TAXES</u> 604 (1987). Congress does not presently appear to be inclined to provide such a permanent exception for small businesses. A recent Dun and Bradstreet study found that businesses with fewer than 100 employees will create about 57 percent of all the new jobs created in the United States in calendar year 1989. <u>See</u> "Small Business Expected To Create Half Of New Jobs," <u>Omaha World Herald</u> (April 20, 1989) at 16-G.

71/Many commentators feel continuation of the system of transactional electivity will continue to reward well-financed and well-advised taxpayers and will penalize other taxpayers. <u>See generally</u> Faber, "The Search for Consistency in Corporate Acquisitions." As discussed in the text <u>supra</u>, one of the main thrusts of the Subchapter C Revision Act is to provide the same set of tax provisions for transactions categorized as complete liquidations, Sec. 338 transactions, and tax-free reorganizations under the 1954 Code.

72/For a discussion of some tax planning strategies and tactics in the post-General Utilities world, see Freeman, "Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsman of the Repeal of General Utilities" and Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal."

73/See Bonovitz, "Taxable Dispositions Of a Corporate Business Before and After TEFRA" at 395. Bonovitz asserts that as a matter of sound tax policy, "there should be a statutory vehicle for taxpayers to treat an asset acquisition as not giving rise to gain recognition to the selling corporation, either treating it as a deemed stock acquisition or by requiring the carryover basis to the purchaser as a trade-off for nonrecognition treatment to the corporate seller." Prior to the enactment of the Tax Reform Act of 1986, Zolt urged Congress to make a basic policy decision whether a "corporation should recognize gain on the transfer of appreciated assets out of the group in instances where the assets remain in corporate form and retain their historic bases." Zolt stated: "Congress should not allow the present situation where substantially equivalent transactions result in different tax consequences." See Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 820.

74/In the opinion of many commentators, the 1954 Code nonrecognition provisions based on the General Utilities doctrine caused a serious lack of symmetry between the tax consequences to the target corporation and its shareholders and the basis rules for the acquiring corporation or individual shareholders. Many commentators felt that the provisions often resulted in completely random tax consequences and that the provisions could not be justified based on the economic substance of the transaction. The fact that the liquidating corporation generally did not have to recognize gain upon the in-kind distribution of appreciated "property" under Section 336(a), generally did not recognize gain upon the liquidating sale of appreciated "property" under Section 337(a), and generally did not recognize gain in Section 338 transactions, because these transactions had the same general tax consequences as Section 337 liquidating sales, but the shareholders of the target or an acquiring corporation could take a stepped-up basis in the target's assets allowed a permanent exclusion from taxation for much of the appreciation in certain assets. In considering arguments for the repeal of these provisions, Congress was impressed with evidence that acquisitive transactions often took unnatural forms in order to take advantage of these corporate level nonrecognition provisions. Congress was also impressed with arguments that these nonsymmetrical tax rules often resulted in unwarranted tax benefits to well-advised taxpayers. See generally Subchapter C Revision Act at 6.

75/Disregarding target corporations which are members of a group of corporations filing a consolidated tax return, most commentators feel that an election under Sec. 338 of the 1986 Code to treat an acquisition of stock as an acquisition of assets is generally not warranted on a present value basis. The Sec. 338 election treats the target corporation (Old T) as hypothetically having sold its assets for their fair markets to a new corporation (New T). Because of the repeal of the General Utilities doctrine, Old T will recognize all realized gain as if it had actually sold its assets for an amount of cash equal to their fair market values. Thus the recognized gain will be taxed to Old T. As is the case for most taxable acquisitions under the 1986 Code, the present value of the tax savings from the increase in tax basis to the acquiring corporation will often be less than the present value of the immediate tax liability for a taxable sale of the assets of the target corporation. In order to avoid a deemed Sec. 338 election under the various consistency rules provided in Sec. 338, the acquiring corporation can, and generally should, make a protective carryover basis election. This election is discussed in Bonovitz, "Making the Protective Carryover Basis Election Under the Sec. 338 Temp. Regs.," 63 J. Tax'n 63 (1985).

76/These issues are discussed and illustrated in Koltarsky, "Stepping Up Basis: Purchase Of Stock Or Purchase Of Assets."

77/See, e.g., Segal and Konselman, "Liquidation-reincorporation: issues and planning in the battle over recharacterization," 18 Tax Adviser 337 (1987).

78/See Tax Reform Act of 1986, Conference Report to accompany H.R. 3838, 99th Cong., 2d Sess., Rept. 99-841 (September 1986) at 198-207.

79/Pub. L. No. 100-203, 101 Stat. 1330 (1987).

80/See generally Schneider and Austrian, "Widespread Changes For Corporations in 1987 Act," 68 J. Tax'n 196 (1988); Strauss and Bush, "Fiscal Year Nonconformity," 19 Tax Adviser 253 (1988); and Willens, "The Corporate Provisions of the Revenue Act of 1987," 19 Tax Adviser 259 (1988) See also Arthur Andersen & Co., Washington Tax Letter "The Revenue Act Of 1987--Tailoring The Sow's Ear" (No. 87-1, April 2, 1987); Deloitte Haskins and Sells, "The 1987 Tax Amendments," (No. 87-27, December 22, 1987); and Ernst & Whinney, Washington Tax Reporter "Tax Reform Again" (No. 66357, January 1988).

81/The repeal of the General Utilities doctrine caused tax planners to revive older methods (such as the mirror subsidiary technique and its variations) or devise new methods (such as the Sec. 304 and Sec. 355 techniques) in order to remove appreciated assets from one corporation without the recognition of gain. The fundamental tax policy issue is whether realized gain should be recognized when appreciated assets are transferred out of one affiliated group of corporations and placed in another affiliated group of corporations but take a carryover basis.

The various types of mirror subsidiary transactions are described in Kliegman, "Do Mirror Transactions Survive the 1986 Act?" 66 J. Tax'n 206 (1987). These elaborate techniques and their intended tax consequences prior to the enactment of the Revenue Act of 1987 are also discussed and illustrated in Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 824-832. Mirror subsidiary transactions were also used to dispose of part of the assets of target corporations after acquisitions in order to reduce acquisition indebtedness.

82/The issue of whether the federal income tax laws should be used in this matter has been debated for many years. See, e.g., AICPA, Statement of Tax Policy No. 5: Taxation of the Formation and Combination of Business Enterprises at 3-4:

> It is not our purpose here to suggest the direction that public policy should or might take in establishing criteria for evaluating the desirability of specific business combinations. We do believe that where public policy dictates that the interests of society are best served by preventing, limiting, or retroactively remedying a particular corporate ac-

quisition or merger, the laws, regulations, and sanctions employed to accomplish these objectives should arise solely outside the income tax law. If these laws, regulations, and sanctions are properly constructed and adequately enforced, there is simply no reason for the tax law to be burdened with concepts that properly lie far beyond the limits of its responsibility. Indeed, any combinations that remain to be dealt with for tax purposes (other than those whose dominant motivation is tax avoidance) would be desirable in a public policy sense and should therefore be facilitated, or at least not hampered, through the operation of 'neutral' taxing provisions.

83/Although the tax consequences of mirror subsidiary transactions under the 1954 Code were fairly certain, the ability to avoid recognition of gain realized upon the distribution of the assets of the target corporation to the controlled (mirror) subsidiaries of the acquiring corporation was in dispute until the enactment of the Revenue Act of 1987. The technical issue was whether the nonrecognition rule of Sec. 337(a) (as amended by the TRA of 1986) was applicable to mirror subsidiary transactions. Sec. 337(a) provides a nonrecognition rule for liquidating corporations that distribute property to an "80 percent distributee" in a complete liquidation to which Sec. 332 applies. Until the amendment to Sec. 337 by the Revenue Act of 1987 it was not clear whether the mirror subsidiaries established by the acquiring corporation to receive the various assets of the target corporation qualified as "80 percent distributees."

The Revenue Act of 1987 added Sec. 337(c) which provides that to be an 80 percent distributee, any corporation must satisfy the 80 percent test by <u>direct</u> stock ownership. The determination of whether any corporation is an 80 percent distributee must be made without regard to any of the consolidated return regulations. Sec. 337(c) is generally effective for distributions made after December 15, 1987.

Most commentators agree that under Sec. 337, as amended by the Revenue Act of 1987, a liquidating subsidiary corporation will recognize all gain realized upon making liquidating distributions to any corporation which is not an 80 percent distributee as defined in Sec. 337(c). Most commentators agree the addition of Sec. 337(c) effectively eliminates the use of the mirror subsidiary technique because the desired nonrecognition of gain by the liquidating corporation was based on the mirror subsidiaries established by the acquiring corporation qualifying as 80 percent distributees by the now disallowed aggregation of ownership under Regs. 1.1502-34.

See generally Lee, "Takeover Pace Is Seen As Picking Up in 1988," Wall St. J.(January 4, 1988) at 2. The elimination of the mirror subsidiary technique will increase the costs of selling subsidiary corporations and will make target corporations having low book values and high fair market values, e.g., those which most benefited from the mirror subsidiary technique, less attractive to acquiring corporations. For a technical descriptions of the effect of the Revenue Act of 1987 on mirror transactions and post-General Utilities transactions eliminated or curtailed by the Revenue Act of 1987, see Nichollas, "1987 Tax Provisions Affecting Corporate Acquisitions and Dispositions," 39 Tax Notes 637 (May 2, 1988); Kliegman, "Do Mirror Transactions Survive The 1986 Act?" and Zolt, "The General Utilities Doctrine: Examining the Scope of the Repeal" at 824-827.

84/The House bill would have enacted a mandatory Sec. 338 approach for hostile qualified stock purchases in which the appreciation in the target's assets would be recognized upon the sale of its assets. The Sec. 338 approach would increase the tax costs of certain hostile takeovers. Leduc and Gordon state:

> Accordingly, the target corporation would be deemed to have sold all of its assets at fair market value in a taxable transaction. A hostile qualified stock purchase was defined as any qualified stock purchase if any significant portion of the stock included in such purchase was acquired pursuant to a hostile tender offer. A hostile tender offer was any offer to acquire such stock of a corporation if a majority of the independent board of directors of such corporation disapproved such offer.

Leduc and Gordon, "Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future" at 37-153 and 37-154.

85/Sec. 5881 reflects the Congressional objective of using the federal income tax system to discourage taxpayers from acquiring the stock of a potential target with the intention of forcing the potential target to subsequently purchase the stock from the potential acquiring corporation at a premium, i.e., the target will pay "greenmail" to the acquiring corporation in order to avoid being acquired in a hostile takeover. If a shareholder receives greenmail (as defined in Sec. 5881(b)), both the new excise tax and the regular income tax will be imposed on the realized gain. The new excise tax will also apply when a shareholder who is otherwise subject to Sec. 5881 sells the corporation's stock to an entity related to the issuing corporation (the potential target corporation), such as a controlled subsidiary.

See generally Levin, "Greenmail Tax Traps For The Unwary," 41 Tax Notes 229 (October 10, 1988) and Lustig, "The Emerging Role of the Federal Tax Law in Regulating Hostile Corporate Takeover Defenses: The New Section 5881 Excise Tax on Greenmail," 40 U. Fla. L. Rev. 789 (1988).

86/Posin," Taxing Corporate Reorganizations: Purging Penelope's Web" at 1353.

87/40 F.2d 937 (2nd Cir. 1932), cert. den. 288 U.S. 599 (1933).

88/Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders at 14-18 and Ferrero, "Continuity of Interest Revisited" at 44-5.

89/Brown, Berkowitz, and Lynch note the early Revenue Acts contained no limitation on the receipt of securities as is contained in Secs. 354, 356, and 368 of the 1954 and 1986 Codes. Under the literal language of the statute, shareholders of the target corporation could therefore "cash in" their equity investment in the target by receiving securities of the acquiring corporation and also obtain deferred recognition of gain. Brown, Berkowitz, and Lynch, "McDonalds of Zion: application of the step-transaction doctrine to the continuity of interest test" at 580-581.

90/In Courtland Speciality, there was no question that the acquiring corporation planned to continue the business conducted by the target. Many commentators feel this apparently gratuitous comment is the origin of the continuity of business enterprise doctrine. See, e.g., Bloom, "The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise" at 315. The income tax regulations have contained a continuity of business enterprise requirement since 1935. See Treas. Reg. 86 Sec. 112(g)-1 (1935).

91/60 F.2d 937 (2nd Cir. 1932) at 940.

92/287 U.S. 462 (1933).

93/See Ferrero, "Continuity of Interest Revisited" at 44-5.

94/287 U.S. 462 (1933) at 463.

95/287 U.S. 462 (1933) at 468.

96/287 U.S. 462 (1933) at 469.

97/287 U.S. 462 (1933) at 470. Other leading continuity of interest decisions include Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Minnesota Tea v. Helvering, 302 U.S. 609 (1938); John Nelson, 296 U.S. 374 (1935); Helvering v. Watts, 296 U.S. 387 (1935); LeTulle v. Scofield, 308 U.S. 415 (1940); Roebling v. Comm., 143 F.2d 810 (3rd Cir. 1944), cert. den. 323 U.S. 773 (1944); Helvering v. Alabama Asphaltic Co., 315 U.S., 179 (1941); and Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942).

98/See Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 240; Michaelson, "'Business Purpose' and Tax-Free Reorganizations"; and Tarleau, "'Continuity of Business Enterprise' in Corporate Reorganizations and Other Corporate Readjustments."

99/221 F.2d 252 (2nd Cir. 1955).

100/27 BTA 223 (1932), rev'd 69 F.2d 809 (2nd Cir. 1934), aff'd 292 U.S. 465 (1935). The Supreme Court's decision in Gregory v. Helvering is responsible for much of the business purpose language in Regs. 1-368-1(b) and 1.368-1(c).

101/293 U.S. 465 (1935) at 469.

102/Faber, "Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?" at 269. Fuller argues the business purpose requirement is a subset of the continuity of business enterprise requirement because the business purpose requirement is evidenced by the acquiring corporation's continuation of the business conducted by the target corporation. See Fuller, "Business Purpose, Sham Transaction And The Relaxation of Private Law To The Law of Taxation" at 362.

103/A discussion of the Service's frequent role reversals in liquidation-reincorporation transactions is contained in Michaelson, "'Business Purpose' and Tax-Free Reorganizations."

104/The leading cases in which the government attempted to characterize liquidation-reincorporation transactions as reorganizations include Graham v. Comm., 37 BTA 623 (1938), acq. 1938-2 CB 13; Standard Realization Co. v. Comm., 10 TC 708 (1948), acq. 1948-2 CB 3; Lewis v. Comm., 176 F.2d 646 (1st Cir. 1949); Pebble Springs Distilling Co. v. Comm., 231 F.2d 288 (7th Cir. 1956), cert. den. 352 U.S. 36 (1956); American Bronze Corp. v. Comm., 64 TC 1111 (1975); Bensten v. Phinney, 199 F. Supp. 363 (S. D. Tex. 1961); Mitchell v. U.S., 451 F.2d 1395 (Ct. Cl. 1971); Atlas Tool Co. v. Comm., 70 TC 86 (1979), aff'd 614 F.2d 860 (3rd Cir. 1980; and Laure v. Comm., 10 TC 1087 (1978).

The leading cases in which taxpayers attempted to characterize liquidation-reincorporation cases as reorganizations include Morley Cyprus Trust, Schedule "B" v. Comm., 3 TC 84 (1944), acq. 1944-1 CB 20 and Wortham Machinery Co. v. Comm., 521 F.2d 160 (10th Cir. 1975).

105/In Comm. v. Transport, Trading & Terminal Corp., 38 AFTR 365 (2nd Cir. 1949), Judge Learned Hand stated:

> The doctrine of Gregory v. Helvering, supra, which we here hold to be controlling, is not limited to cases of corporate reorganizations. It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no motive but to escape taxation.

106/Representative tax-free reorganization cases in which the business purpose doctrine was a central issue include James Realty Co., 197 F. Supp. 306 (D.C. Minn. 1959), aff'd 280 F.2d 394 (8th Cir. 1960) (tax-free reorganization involves a reformation or remolding of a corporate business and not the payment of a dividend to the shareholders); Nadeau v. U.S., 181 F. Supp. 752 (D.C. W.D. Mich. 1960) (to obtain reorganization treatment the transaction must comply with the literal language of the statute and have a legitimate business purposes as stated in Gregory v. Helvering); Diggs v. Comm., 281 F.2d 593 (2nd Cir. 1937) (Gregory v. Helvering puts a heavy burden on taxpayers who attempt to demonstrate that Congress intended to give favorable tax treatment to transactions that would never have occurred absent the motive to avoid taxation); Knetsch v. U.S., 364 U.S. 361 (1960) (the form of the transaction adopted by the taxpayer will generally be respected by the Internal Revenue Service and the courts except when it is a patent disruption of normal business practice); Portland Manufacturing Co. et. al., 56 TC 58 (1971) (taxpayer has a right to minimize tax liability by proper tax planning. The court stated: Taxpayer cannot use tax alchemy whereby mixing a brew of incorporation, conveyance, and liquidation, and incanting the language of deeds, bills of sale and corporate minutes, a taxable exchange is changed into a tax-free reorganization.); John Stoll Estate et. al., 38 TC 223 (1962) and Epstein et. al. v. U.S., 221 F. Supp. 479 (D.C. N.D. Ohio 1963) (sound business purposes include the profitable perpetuation of a business and compliance with applicable laws); and Weyl-Zuckerman & Co., 73 TC 841 (1955) (sound business purpose must be demonstrated by taxpayer's deeds rather than his statements or intentions).

107/Holzman, Tax-Free Reorganizations at 379. See also Holzman, "Ten Years of the Gregory Case," 79 J. Acct. 215 (1945).

108/In Gregory v. Helvering, the courts had to decide whether a series of transactions which satisfied the literal requirements for a divisive reorganization under Sec. 112(g)(1)(D) of the Revenue Act of 1924 but which was clearly undertaken for tax avoidance reasons should be allowed the tax-free reorganization treatment desired by the taxpayer. Mertens notes Gregory was the first case heard by the Supreme Court in which the new corporation formed to receive the assets "spun off" from an existing corporation had no apparent purpose other than to serve as "a temporary corporate device created solely to avoid taxation and to pass out and distribute to a corporate shareholder a taxable dividend, without the payment of income tax thereon." Mertens Law of Federal Income Taxation at 222. Because the trial, appellate, and Supreme Court decisions have been analyzed so frequently in the tax literature, those discussions will not be repeated here. See Andrews, Federal Income Taxation of Corporate Transactions at 107-113.

109/Sec. 112(g)(1)(D) of the Revenue Act of 1924 defined the type of tax-free reorganization attempted in Gregory as "a transfer by a corporation of all or part of its assets to another corporation if, immediately, after the transfer, the transferor or its shareholders or both are in control of the corporation to which the assets are transferred." Although Sec. 112(g)(1)(D) did not literally prohibit the transactions arranged by the taxpayer, the Second Circuit and the Supreme Court noted the rather blatant attempt at tax avoidance was not within the spirit of the law principally because the formation of a controlled corporation which was completely liquidated immediately after its formation and used for no reason other than to distribute appreciated assets to the taxpayer had no "business purpose."

110/27 BTA 223 (1932) at 225.

111/69 F.2d 809 (2nd Cir. 1934). Spear criticizes this opinion as "brilliantly written to justify judicial legislating through the medium of statutory interpretation." Spear, "'Corporate Business Purpose' in Reorganizations" at 234.

112/393 U.S. 465 (1935) at 469-470.

Endnotes--Appendix B

1/Graetz, "The Tax Aspects Of Leveraged Buyouts And Other Corporate Financial Restructuring Transactions," 42 Tax Notes 721 (February 6, 1989).

2/See 1985 Hearings on Reform of Corporate Taxation at 82. The Treasury Department did not state how the needed empirical research should be performed or propose the use of different research methodologies than have been used and reported in the empirical literature.

3/DeArment, "Introductory Remarks On The Senate Finance Committee Staff's Final Report on Subchapter C, The Subchapter C Revision Act of 1985," 5 Va. T. Rev. 595 (1986) at 596.

4/See 1985 Hearings on Reform of Corporate Taxation at 165.

5/See Id.

6/See Id., at 166.

Greer has identified one motive for mergers and acquisitions which he states is difficult to document and impossible to measure statistically or quantitatively and which has largely escaped the notice of economists. The motive is that corporations often acquire other corporations in order to avoid being acquired themselves. See Greer, "Acquiring in order to avoid acquisition," XXXI Antitrust Bull. 155 (1986).

Although he does not discount the possibility of an industry undergoing a flurry of merger activity as a result of a real contraction or consolidation, Greer notes a defensive aspect of acquisitions even under these circumstances:

> As an industry's membership contracts, the management of each firm may correctly perceive that its position of managerial control is contingent upon its becoming an aggressive buyer. Under the circumstances, failure to secure a solid strategic position through acquisition raise the firm's exposure to oblivion as an independent entity. In short, a firm may be motivated to seek some high ground in a fluid situation.

Id., at 165.

Greer notes that empirical evidence on the defensive motive for mergers and acquisitions is difficult to obtain and not readily detected by statistical methods:

> If acquisitive managers candidly declared the true reasons for their corporate purchases, the problems would be of little consequence. But we cannot expect frankness. The motive is very self-serving, much like the motive of personal aggrandizement. Other, more laudable motives, such as enhanced efficiency, will usually be voiced instead.

Id., at 158.

Greer rejects the arguments of the Chicago School (the University of Chicago) that explicitly state or implicitly assume that the market for corporate control is highly competitive and that the shareholders of the target corporation ultimately benefit economically from vigorous rivalry among potential acquiring corporations. Advocates of the Chicago School position and others who argue for limited federal government interference with the market for corporate control usually base their arguments on the improved-management theory (i.e., that actual or potential corporate takeover will replace weak managers with stronger managers which will ultimately benefit corporate shareholders). The improved-management theory assumes: (1) the acquiring firm has average or above average performance before a corporate acquisition; (2) the target firm suffers from below average performance before a corporate acquisition; and (3) the performance of the target corporation improves after a corporate acquisition. See Id., at 171-173.

Greer asserts there is no conclusive evidence that a competitive market for corporation control exists and that the improved-management theory cannot be used to justify the Chicago School position:

> . . . there is no body of statistical evidence that is fully consistent with the existence of an efficient and competitive market for corporate control. It has not been shown that, in general (1) poorly performing companies are (2) acquired by firms performing better than themselves, with the result that (3) the two together experience improved performance.

Id., at 175.

Greer notes that the empirical studies report: (1) Acquiring firms tend to be larger than comparable firms in the economy and enormously larger than the firms they acquire.

(2) Acquired firms tend to be smaller than the average firms in their industries. (3) Acquiring firms tend to be highly leveraged or more highly leveraged than the firms they acquire. See Id., at 179.

Greer states:

> Why, if acquisitions are supposed to serve the purpose of purging unbridled and bungling managements, are the largest and most highly leveraged corporate managements so singularly spared [from hostile takeovers]? Huge size and oppressive debt may in many instances be more indicative of size maximization and poor judgment--the two things corporate control acquisitions are said to correct--than indicative of profit maximization of the shareholders, which in corporate control theory is what secures shelter against a takeover. Stated differently, those who live by the sword may die by the sword, but those who live by the acquisition may not necessarily die by acquisition, not even if living very raggedly from a shareholder's standpoint and especially not if they are fanatical acquirers. The experiences of LTV, Litton, Gulf and Western, ITT and other such conglomerates indicate as much.

Id., at 180.

Greer notes there is much anecdotal, and some empirical, evidence that corporate size and the likelihood of being taken over in an unfriendly transaction are inversely related. Greer asserts that the lessons taught by the anecdotal evidence have not been lost on top managers and the board of directors of corporations wishing to maintain their independence. See Id., at 159. Greer states that gaining an increased corporate size was one of the main reasons why Beatrice Food Company attempted to acquire Esmark, Inc. for $2.5 billion in 1984. Greer states that the fact that several large oil companies, including Gulf Oil, Getty Oil, Conoco, and Marathon Oil, have been acquired in recent years does not violate the hypothesized inverse relationship between corporate size and the probability of being taken over in a hostile transaction. The primary reason for the takeovers of these oil companies is that the nature of oil industry allows acquiring corporations to obtain bank financing for acquisitions relatively easily. See Id.

Greer does note that some empirical research on stockholder returns supports the notion that if a corporation makes defensive acquisitions (i.e., makes acquisitions in order not to be acquired by another corporation) the shareholders may suffer lower than normal returns because of the reduced possibility that the corporation will itself be acquired by another corporation. See Malatesta, "The Wealth Effect of Merger Activity and the Objective Function of Merging Firms," 11 J. Fin. Econ. 155 (1983).

Greer asserts that lawyers and other takeover strategists often recommend that potential target corporations make defensive acquisitions financed largely with debt in order to increase their debt-equity ratios, issue stock to the present shareholders with poison pill rights to make itself less attractive to potential acquiring corporations, make a "regulated buy" to increase the chances that an acquiring corporation will face antitrust or other legal impediments, or use the "Pac-Man" defense in which a counter tender offer is made for the potential acquiring corporation. See Id., at 161-162, 168.

In 1969, Northwest Industries proposed a $1 billion tender offer for B. F. Goodrich Corporation. Because Northwest's holdings included a railroad, Goodrich acquired Motor Freight Corporation of Terre Haute, Indiana for about $3 million of Goodrich stock. Goodrich correctly anticipated that the Interstate Commerce Commission would oppose Northwest's takeover of Goodrich because it does not generally favor railroads and trucking firms being owned by the same corporation.

7/1985 Hearings on Reform of Corporate Taxation at 158-159.

8/See Id., at 161. Auerbach notes that, in theory, the benchmark which should be used to determine if the tax law is neutral as to mergers and acquisitions is a hypothetical tax system in which a firm's incentive to combine is not influenced by the tax system. One means to implement this benchmark is to determine whether the aggregate taxes of the corporations and shareholders involved remain the same in the face of a decision to combine with another firm.

Kiefer's research on the acquisition proposals identified the following structural aspects (i.e., nonneurtalities) of the law which may encourage mergers and acquisitions:

1. The existence of a separate corporate tax on corporate income results in the double taxation of corporate income and results in a general disincentive to operate a business in corporate form.

2. The differential treatment of debt and equity in the corporate sector creates incentives for corporations

to have higher debt-equity ratios. There is some evidence that in recent years corporations have "leveraged up" largely through mergers and acquisitions or, alternatively, through financial restructurings in response to an actual or perceived threat of a hostile takeover.

3. The nonrefundability of tax benefits suggests that business activities which generate large tax benefits for sizeable temporary or periodic losses provide a higher rate of return if the tax benefits can be used to offset taxable income from other business activities. Mergers and acquisitions are one way in which unuseable tax benefits can be shifted to those corporations who can most profitably use them.

4. Double taxation of corporate income and, under the 1954 Code, lower tax rates on long-term capital gains for individual taxpayers puts pressure on mature firms to continue reinvesting in the corporation rather than paying more dividends. Mergers and acquisitions are often an attractive means to reinvesting earnings in the face of declining internal investment opportunities.

See 1985 Hearings on Reform of Corporate Taxation at 174-165.

9/See Steiner, Mergers: Motives, Effects, Policies at 75. Much of the recent empirical literature on mergers and acquisitions is discussed in Krinsky, Rotenberg, and Thornton, "Takeovers--A Synthesis," 7 J. Acct. Lit. 243 (1988).

Recent econometric and statistical studies generally do not support the hypothesis that the increase in acquisitive transactions in the United States in the 1980s (the so-called megamerger era) has occurred primarily due to the provisions of the 1954 Code or that attempting to obtain tax benefits or synergies have played a major role in merger and acquisition decisions. The empirical literature lends little support to the contention that the federal income tax laws create a perpetual merger machine: the tax laws subsidize both mergers and the operation of the firm after the merger, thereby encouraging more mergers and concentration of economic power.

The literature indicates that a number of methodological problems exists in operationalizing the variables of interest and in otherwise isolating the relative importance of the tax laws and nontax factors in merger and acquisition decisions. The discrepancy between the relative high predictive ability of statistical models and the stock market itself (which does not seem to be able to predict acquisition targets with either a high degree of consistency or accuracy) suggests to many commentators the existence of methodological problems or perhaps a fundamental inability to understand or model the corporate takeover process.

See generally Fisher and Lande, "Efficiency Considerations in Merger Enforcement," 71 Calif. L. Rev. 1619 (1983) (asserts that econometric "proof" of the efficiency effects of mergers and acquisitions is not possible); Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis," 8 J. Acct. & Econ. 3 (1986); and Breen, The Potential For Tax Gains As A Merger Motive (Bureau of Economics, Federal Trade Commission, 1987).

Palepu notes three major methodological problems which suggest that the predictive ability of prior models reported in the literature (i.e., the ability to predict target and nontarget corporations) is seriously overstated. These are sampling for model estimation, sampling for prediction tests, and specification of the cutoff probability. See Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis" at 6-15.

Breen's review of the empirical literature "clearly indicates" the need to operationalize more accurately and completely the often competing and often offsetting tax variable of interest and the need to utilize different research methodologies to better isolate the effect of the Code on merger and acquisition decisions. Breen has identified the following methodological problems facing those who try to investigate empirically the tax incentives for merger and acquisition activity:

1. The tax variables are difficult to operationalize and model due to data limitations, restrictions and limitations on the uses of tax benefits, and offsetting costs (e.g., the cost of rearranging the corporation's affairs in a legal form which will take advantage of the tax provisions).

2. Difficulties in specifying, modeling, and measuring the various non-acquisition methods of realizing potential tax gains limit the internal validity of the resulting models.

3. The merger incentive allegedly produced by the deductibility of interest on debt-financing should be

modeled more carefully and should be included in any studies of step-up and carryover basis transactions and carryover basis transactions and the impact of the historical differential between tax rates for long-term capital gains and ordinary income.

4. Greater consideration must be given to possible non-tax determinants of why firms merge in order to design unbiased tests of the tax-incentive hypothesis.

See Breen, The Potential For Tax Gains As A Merger Motive at 39.

5. The principal non-tax factors which should be considered in order to make an unbiased estimate of the effect of the tax provisions on merger decisions include:

   a. Many commentators feel the recent increase in merger activity can be explained or rationalized in macroeconomic terms, including capital market and stock market considerations and changes in the pace of business activity.

   b. The trend toward large scale mergers may be due to innovation in takeover technology that have reduced the costs of financing large-scale acquisitions.

   c. Many commentators feel that mergers reflect a fundamental restructuring of basic industries in the United States. Examples include capacity reductions in the oil and gas industry and restructuring of financial markets due to deregulation initiatives.

   d. Other commentators feel that mergers reflect adjustments of older industries due to increased foreign competition.

   e. There is some support for the notion that the increase in number and size of transactions reflects a change in attitude and enforcement of the antitrust and related laws under the Reagan administration.

See Breen, The Potential For Tax Gains As A Merger Motive at 45.

10/See Poterba, "Comment" in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 186. As discussed in Chapter III of this Study, some anecdotal evidence suggests that tax considerations play a more important role for smaller and closely-held corporations.

11/See Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis."

12/As is often the case for binary state predictions (e.g., a specific firm is either a target or a nontarget corporation in a certain time period), the various versions of Palepu's models used a logit probability function to specify the exact functional relationship between the characteristics of a firm and the likelihood of the firm being acquired in a given period. The intuition underlying the model is summarized below:

1. Whether or not a firm is acquired in a particular time period depends on the type of acquisition bids it receives.

2. The type of acquisition bids a firm receives depends on the firm's own characteristics as well as the motives and attributes of the bidders.

See Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis" at 15.

13/See Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis" at 16-19.

14/See Id., at 30.

15/See Breen, The Potential For Tax Gains As A Merger Motive. The principal studies reviewed by Breen are summarized at 47-68.

16/See Id., at 1-3.

17/See Id., at 1.

18/See Id., at 17.

19/See Id., at 1.

20/See Id., at 40.

21/Id.

22/See Id., at 46.

23/Id., at 46-48.

24/See Id., at 1-2.

25/See, e.g., Adams and Heinforth, "The effect of conglomerate mergers on changes in industry concentration," XXXI Antitrust Bull. 133 (1986); Auerbach and Poterba, "Tax-Loss Carryforwards and Corporate Tax Incentives," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 305-342; Auerbach and Reishus, "The Effects of Taxation on the Merger Decision," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 157-187; Brown and Medoff, "The Impact of Firm Acquisitions on Labor," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 9-31; Comment and Jerrell, "Two-Tier And Negotiated Tender Offers," 19 J. Fin. Econ. 283 (1987); Ferris and Reichenstein, "A Note On The Tax-Induced Clientele Effect and Tax Reform," XLI Nat'l Tax J. 131 (1988); Franks, Harris and Mayer, "Means of Payment in Takeovers: Results for the United Kingdom and the United States," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 221-258; Charest, "Dividend information, stock returns, and market efficiency II," 6 J. Fin. Econ. 287 (1988); Giammarino and Heinkel, "A Model of Dynamic Takeover Behavior," XLI J. of Fin. 465 (1986); Golbe and White, "A Time-Series Analysis of Mergers and Acquisitions in the U.S. Economy," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 265-302; Grossman and Hart, "Takeover bids, the free-rider problem, and the theory of the corporation," 11 Bell J. of Econ. 42 (1980); Haung and Walkling, "Target Abnormal Returns Associated With Acquisition Announcements, " 19 J. Fin. Econ. 329 (1987); Hirschey, "Mergers, Buyouts and Fakeouts," 76 Am. Econ. Rev. 317 (1986); Holderness and Sheehan, "Raiders Or Saviors? The Evidence on Six Controversial Investors," 14 J. Fin. Econ. 555 (1985); Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," 76 Am. Econ. Rev. 323 (1986); Johnson and Siegel, "Corporate Mergers: Redefining The Role of Target Directors," 136 U. Pa. L. Rev. 315 (1987); Knoeber, "Golden Parachutes, Shark Repellants, and Hostile Tender Offers," 76 Am. Econ. Rev. 155 (1986); Lipton, "Corporate Governance in the Age of Finance Corporatism," 136 U. Pa. L. Rev. 1 (1987); Pound, "The Effects Of Antitakeover Amendments On Takeover Activity: Some Direct Evidence," XXX J. L. and Econ. 353 (1987); Scharfstein, "The Disciplinary Role of Takeovers," LV Rev. Econ. Stud. 185 (1988); Shleifer and Summers, "Breach of Trust in Corporate Takeovers," in Auerbach (ed.), Corporate Takeovers: Causes and Consequences at 33-67; Shoven, "The Tax Consequences of Share Repurchases and Other Non-Dividend Cash Payments to Equity Owners," in Summers (ed.), Tax Policy and the Economy at 29-54; Stiglitz and

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26/See generally Stigler, "Do Economists Matter?" 42 S. Econ. J. 347 (1976) and Gellhorn, "The Practical Uses of Economic Analysis: Hope vs. Reality," 56 Antitrust L. J. 933 (1988). Gellhorn states: "The general purpose of economic analysis is to explain behavior and predict consequences." Gellhorn notes that the utility of economic analysis often depends on the questions being asked and answered. Id., at 933.

27/See Hendershott, "Tax Reform and Economic Growth," 40 Tax Notes 525 (August 1, 1988). For a discussion of some economic research conducted prior to and after the enactment of the TRA of 1986 see Venti and Wise, "IRAs and Saving," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 7-51; Mankiw, "Consumer Spending and the After-Tax Real Interest Rate," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 53-68; Lindsey, "Capital Gains Rates, Realizations, and Revenues," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 69-100; Feldstein and Jun, "The Effects of Tax Rules on Nonresidential Fixed Investment: Some Preliminary Evidence from the 1980s," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 101-161; Auerbach and Hines, "Anticipated Tax Changes and the Timing of Investment," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 163-200; Gordon, Hines, and Summers, "Notes on the Tax Treatment of Structures," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 223-257; Hendershot, "Tax Changes and Capital Accumulation in the 1980s," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 259-294; Summers, "Investment Incentives and the Discounting of Depreciation Allowances," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 295-304; and Majd and Myers, "Tax Asymmetries and Corporate Income Tax Reform," in Feldstein (ed.), The Effects of Taxation on Capital Accumulation at 343-376.

28/A similar situation seems to have arisen in early 1989 with respect to leveraged buyouts. Concerned with a number of leveraged buyouts of large publicly held corporations financed largely with junk bonds and with the substitution of debt for equity in many large United States corporations, the tax-writing and other Congressional Committees held a number of hearings in early 1989. Congress seems reluctant to limit the deductibility of interest expense or make other major changes in the federal income tax laws because the changes may have major unanticipated domestic and international economic ramifications. See generally Birnbaum, "Congressional Action on LBOs Slows to Dragging Feet," Wall St. J. (March 9, 1989) at C1 (Congress is reluctant to consider enacting major changes in the Code without strong leadership from the Treasury Department. Congress is also concerned that major changes in the Code could hurt the competitive position of the United States in world trade.)

See also Matthews, "Pearlman Does Not Forsee LBO-Driven Tax Changes," 42 Tax Notes 904 (February 20, 1989) (Ronald Pearlman, Chief of Staff, Joint Committee on Taxation, states there is a strong possibility that Congress will make no changes in the Code in 1989 to reduce the incentives for LBOs) and Louden, "Role of Securities Regulations And Foreign Investors in LBOs Examined," 42 Tax Notes 1412 (March 20, 1989) (the majority of witnesses testifying before the House Ways and Means Committee suggested that Congress make no changes in the Code in 1989 to discourage LBOs due to uncertain economic consequences of limiting the deductibility of interest expense, etc).

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