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TAX INCENTIVES AND THE CONGLOMERATE MERGER: AN INTRODUCTION†

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The desirability and feasibility of buying or selling a business will often turn upon the tax consequences of the transaction to either the buyer, the seller or both parties. The principal concerns of the buyer are (1) whether the assets of the acquired business will have a basis in the buyer's hands (for purposes of depreciation and the measurement of gain upon a subsequent sale) equal to their fair market value or a carry-over of the seller's basis, and (2) whether periodic payments, if any, to the seller with respect to the purchase price will be deductible by the buyer. Conversely, the principal concerns of the seller are (1) whether and when gain realized on the sale (*i.e.*, the excess of the consideration received over the basis in the stock or assets sold) will be subject to tax, and (2) whether such gain will be taxable as capital gain or ordinary income.

The reader's understanding of the tax problems attending corporate acquisitions and the recent amendments to certain provisions of the tax law affecting these acquisitions should be assisted by the following explanation, in general terms, of the tax consequences of such transactions.

Acquisitions by corporations of the stock or assets of businesses operating in the corporate form are broadly categorized as "tax-free reorganizations" and "taxable transactions."

A tax-free reorganization can be accomplished in several forms: (1) a statutory merger[1] (commonly referred to as an "A reorganization"), (2) an acquisition of stock by a corporation which after the acquisition owns at

† To aid the reader the following short forms of citation have been utilized throughout this section:

1 All references to the House version of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., 1st Sess. (1969), will be cited as House Version.

2 All references to the Senate version of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., 1st Sess. (1969), will be cited as Senate Version.

3 References to both the House and Senate versions of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., 1st Sess. (1969), will be cited as Tax Reform Act.

4 All references to sections of the Tax Reform Act of 1969, as they were originally numbered in committee will be in the form

a. H.R. 13270, at §, or

b. S. BILL §

5 All references to Conference Committee version of the Tax Reform Act of 1969, H.R. REP. No. 782, 91st Cong., 1st Sess. (Dec. 21, 1969) will be cited as H.R. REP. 782.

6 Internal Revenue Code of 1954 will be cited as I.R.C.

7 S. REP. No. 552, 91st Cong., 1st Sess. (1969) will be cited as S. REP. 552.

8 H.R. REP. No. 413, 91st Cong., 1st Sess. (1969) will be cited as H.R. REP. 413.

9 SECTION OF TAXATION, A.B.A., *Report on H.R. 13270, Tax Reform Act of 1969* (1969) will be cited as ABA REPORT.

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1 *See* I.R.C. § 368(a)(1)(A).

least 80 percent of the stock of the acquired corporation (commonly referred to as a "B reorganization")[2] and (3) an acquisition of all or substantially all[3] of the assets of the acquired corporation[4] (commonly referred to as a "C reorganization"). The only consideration that can be paid by the acquiring corporation in a B or C reorganization is voting stock of the acquiring corporation or its parent corporation, except that in a C reorganization the acquiring corporation may also assume liabilities of the acquired corporation.[5] On the other hand, in an A reorganization any consideration permitted by the applicable state law may be used, subject only to the continuity of shareholder interest requirement.[6] In order to satisfy this requirement the shareholders of the acquired corporation must in the aggregate have a continuing interest through stock ownership in the acquiring corporation equal in value to a major part of the value of their shareholder interests in the acquired corporation.[7] In determining whether the required continuing shareholder interest exists as of the time of the acquisition, any of the stock of the acquiring corporation which the acquired corporation's shareholders have arranged to sell is regarded as consideration other than stock.[8]

The tax consequences of a so-called tax-free reorganization are as follows: No gain is recognized by the acquired corporation.[9] The basis of the assets of the acquired corporation in the hands of the acquiring corporation is a carry-over of the acquired corporation's basis.[10] Each of the shareholders of the acquired corporation recognizes gain (but not loss) only to the extent that he receives property other than stock of the acquired corporation or its parent.[11] If some of the shareholders of the acquired corporation receive stock and other shareholders receive property other than stock the gain recognized by those shareholders receiving other property will constitute capital gain. On the other hand, if the other property is distributed pro rata among all of the shareholders of the acquired corporation, the gain recognized by each of them will be taxed as a dividend to the extent of his ratable share of the acquired corporation's earnings and profits, with the balance taxed as a

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[2] *Id.* § 368(a)(1)(B), (c).

[3] For ruling purposes, the Internal Revenue Service requires that at least 90 percent of the fair market value of the net assets and 70 percent of the fair market value of the gross assets be acquired. *See* Rev. Proc. 66-34, 1966-2 CUM. BULL. 1233, § 301.

[4] *See* I.R.C. § 368(a)(1)(C).

[5] *Id.* § 368(a)(1)(B), (C). *See also* Turnbow v. Commissioner, 368 U.S. 337 (1961).

Under the seldom-used exception of section 368(a)(2)(B) property other than voting stock may constitute part of the consideration in a C reorganization, provided that the voting stock portion of the consideration has a fair market value equal to at least 80 percent of the fair market value of the gross assets of the acquired corporation.

[6] *See* Treas. Reg. § 1.368-1(b) (1955).

[7] *See* Rev. Proc. 66-34, 1966-2 CUM. BULL. 1233, § 3.01. For ruling purposes the Internal Revenue Service requires continuity of at least 50 percent.

[8] *Id.*

[9] *See* I.R.C. § 361.

[10] *Id.* § 362(b).

[11] *Id.* §§ 354(a), 356, 368(b).

capital gain.[12] Dividends paid on the stock used as consideration for the acquisition will not be deductible by the issuing corporation.

The tax consequences of a "taxable transaction" include the following: no gain is recognized by the acquired corporation, provided that the transaction takes the form of a sale of stock or the acquired corporation is completely liquidated within a one-year period.[13] The acquiring corporation obtains an aggregate basis in the assets of the acquired corporation equal to the total purchase price, provided that the assets of the acquired corporation are transferred to the acquiring corporation either in the original acquisition transaction[14] or upon the liquidation of the acquired corporation pursuant to a plan adopted within two years of the acquisition.[15] The shareholders of the acquired corporation are fully taxable on the gain recognized (usually as a capital gain[16]) in the year in which they sell the stock of, or liquidate, the acquired corporation,[17] except that in the case of a sale of stock the payment of tax by the shareholders of the acquired corporation may be deferrable to the extent that the consideration received consists of debt obligations of the acquiring corporation and qualifies for reporting under the installment method.[18] Interest paid by the acquiring corporation on indebtedness incurred in the acquisition is deductible.[19]

Analysis of the interrelationship of the rules governing the tax consequences of tax-free reorganizations and taxable transactions points up a number of problems.

1. From an economic standpoint (*i.e.*, ignoring tax consequences) there may be little difference between an acquisition that qualifies as a tax-free reorganization and an acquisition that is a taxable transaction. For example, the consideration in a tax-free reorganization may be preferred stock which by its terms the issuer must redeem after a five-year period.[20] Assuming that the acquiring corporation is financially sound, there would appear to be little difference between the position of the holder of such preferred stock

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[12] *Id.* § 356(a)(2).

[13] *Id.* § 337. There are, however, exceptions for depreciation recapture [see I.R.C. §§ 1245, 1250]; unused bad debt reserves [see West Seattle Nat'l Bank v. Commissioner, 288 F.2d 47 (9th Cir. 1961). *But cf.* Mountain States Mixed Feed Co. v. United States, 245 F. Supp. 369 (D. Colo. 1965), *aff'd on other grounds*, 365 F.2d 244 (10th Cir. 1966). *See also* Rev. Rul. 57-482, 1957-2 CUM. BULL. 49.]; and, possibly, assets for which a deduction was previously obtained [see Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969), *petition for cert. filed*, 38 U.S.L.W. 3093 (U.S. Sept. 12, 1969) (No. 583), *rev'g* 48 T.C. 815 (1967). *But see* Spitalny v. United States, 288 F. Supp. 650 (D. Ariz. 1968). *See also* Rev. Rul. 61-214, 1961-2 CUM. BULL. 60.]

[14] *See* I.R.C. § 1012.

[15] *Id.* § 334(b)(2).

[16] *Id.* §§ 1221, 1222. *But cf.* I.R.C. § 341.

[17] *Id.* §§ 331, 1001, 1002.

[18] *Id.* § 453.

[19] *Id.* § 163(a).

[20] The Internal Revenue Service has issued private rulings upholding the characterization of such securities as stock.

and the holder of a subordinated debt security. On the other hand, although convertible debentures are treated as property other than stock, their conversion feature provides the holder with all of the benefits of stock ownership except voting power.[21]

2. The rules as to the type of consideration that can be used in a tax-free reorganization differ sharply, depending on the form of transaction employed. Thus, property other than stock may be used in an A reorganization but not in a B or (for all practical purposes) a C reorganization. There does not appear to be any sound basis for this distinction.

3. It follows therefore, that the parties may virtually always cast an acquisition as a taxable transaction, merely by using a form other than a statutory merger and providing for some non-stock consideration.[22]

4. The continuity of interest requirement is complied with if a major portion of the shareholder interests in the acquired corporation are converted into shareholder interests in the acquiring corporation. There is no requirement that the shareholders of the acquired corporation obtain any degree of control in the acquiring corporation.[23]

5. Because the continuity of interest requirement takes account of sales of the stock of the acquiring corporation by the shareholders of the acquired corporation, the action of one such shareholder can affect the tax consequence of the other.

6. The decision as to whether an acquisition is to be consummated as a tax-free reorganization or a taxable transaction is often a trading off of tax benefits. Since the tax-free reorganization ordinarily is more favorable to the seller (*i.e.*, non-recognition of gain) while the taxable transaction is more favorable to the buyer (*i.e.*, step-up in basis of acquired assets and deduction for interest on debt incurred in purchase) the form of the transaction will usually be a factor in the determination of the purchase price.

In recent years, however, with the advent of large scale acquisition programs by the conglomerates, the use of convertible debentures or debentures plus stock purchase warrants as consideration for acquisitions have become popular.[24] Prior to the enactment of the Tax Reform Act of 1969 the use of such consideration appeared to reconcile the tax desires of both parties to the transaction. The buyer would obtain a stepped-up basis in the acquired assets and deductions for interest paid on the debentures. The seller could defer the reporting of the gain until such time as the debentures were dis-

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21 The rate of interest on the convertible debentures will often be greater than the dividend rate on the stock into which it is convertible, due, in large part, to the fact that interest payments are deductible.

22 Such other consideration should be more than nominal in amount. *Cf.* Richard M. Mills, 39 T.C. 393, 404 (1962) (dissenting opinion), *rev'd*, 331 F.2d 321 (5th Cir. 1964).

23 The continuity of interest requirement should be compared with the proposed rule for pooling of interest accounting treatment, which would take account of relative sizes of acquiring and acquired corporations. *See* 3 AICPA, ACCOUNTING RESEARCH ASSOCIATION No. 1, at 1 (Feb. 2, 1970).

24 *See* H.R. REP. 413, pt. 1, at 102-03.

posed of or converted into stock.[25] Accordingly, from the seller's vantage the only differences in tax consequences between a taxable transaction involving convertible debentures or debentures plus warrants and a tax-free reorganization was that in the case of the taxable transaction (1) gain would be recognized at such time as the debentures were redeemed, converted into stock, or applied to the purchase price of the stock upon exercise of the warrants, and (2) the benefit of the provision stepping up basis to fair market value at death, and thereby avoiding income tax on any gain, would be lost.

Because of professed Congressional concern that the use of debentures in acquisitions was leading to unsound corporate financing and a policy decision that the deferral of gain in transactions other than tax-free reorganizations is inappropriate where the seller receives debt securities which are readily marketable,[26] Congress amended the Internal Revenue Code to disallow or limit the interest deduction where a corporation incurs excessive debt in connection with acquisitions[27] and to deny use of the installment method where the seller receives debt instruments which are readily marketable.[28]

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[25] If debentures plus warrants, rather than convertible debentures, were used, it appeared that gain was reportable immediately to the extent of the value of the warrants. *Cf.* Treas. Reg. § 1.1232-3(b)(2)(i) (1968). The reason for using debentures plus warrants, rather than convertible debentures, was doubt as to whether convertible debentures qualified for installment reporting.

[26] *See* H.R. REP. 413, pt. 1, at 104-07.

[27] Tax Reform Act of 1969 § 411, I.R.C. § 279 (new).

[28] *Id.* § 412, I.R.C. § 453 (amend.).