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IMPACT OF THE ACQUISITION INDEBTEDNESS PROVISIONS OF THE TAX REFORM ACT OF 1969 ON CORPORATE MERGERS

LEONARD L. SILVERSTEIN*

The crescendo which the corporate merger movement in the United States had reached in late 1968 and early 1969 was sharply interrupted by the sudden and harshly strident note struck by House Ways and Means Committee Chairman, Wilbur D. Mills, when he introduced H.R. 74891 on February 24, 1969.

That Bill, the significance of which was signalled by the Chairman's personal sponsorship,2 would have disallowed the deduction for interest paid or accrued by a corporation with respect to debt issued as consideration in connection with a plan of acquisition of stock of another corporation.3 H.R. 7489 also denied installment method treatment of reporting gain to sellers of shares in exchange for corporate debt issued "with interest coupons or in registered form."4

The echo resounding from Chairman Mills' thunderclap, while first heard before the Congress was wholly committed to broad tax revision, proved to be a significant aspect of H.R. 13270, the Tax Reform Act of 1969. As the content of the measure was refined in the legislative process, the dimensions of the statute (now section 279 of the Code)5 were considerably narrowed. And although the alteration in the statute's scope may be attributed in part to the normal evolution of the tax legislation, commentary presented at the hearings and specific issues raised by affected parties suggest that the ultimate message delivered by the 1969 legislation is the signal, publicly given, that its terms represent the first of several stages of a general reexamination of the Federal tax treatment of corporate combinations.

This paper will describe briefly the setting within which H.R. 7489

* Member of the District of Columbia Bar. A.B., Yale University, 1943; LL.B., Harvard University, 1948.
2 Preceding the introduction of H.R. 7489, Chairman Mills issued a press release in which he "expressed his concern with the increasing trend in recent months towards conglomerate mergers." Mr. Mills questioned "whether it was good either for the shareholders or for the economy as a whole for these conglomerate mergers to occur." He "urged companies to go slow in conglomerate mergers if they are depending upon any of the tax provisions . . . for the success of their mergers." House Committee on Ways and Means Release (Feb. 10, 1969).
3 HR 7489 § 277.
4 Id.
5 Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 [hereinafter cited as I.R.C.], as amended by the Tax Reform Act of 1969.
was introduced and, by comparing it with section 279 and the related debt discount and premium provisions of the 1969 legislation as finally enacted, will seek to analyze the role which these rules play in terms of effecting nontaxable corporate combinations under present law. From the foregoing, it is hoped some perspective may be derived from which the anticipated reexamination of the merger field more generally may be viewed.

I. BACKGROUND

If the newsworthiness of technical tax matters is a test of financial and popular viability, it also is a manifestation that a high water mark in use has been reached or, as often the case, has already passed. Such appears to have been the situation in the early part of 1969. The preceding year had accounted, the Ways and Means Committee observed, in large acquisitions exceeding $12 billion, a dollar amount which was triple the average rate of manufacturing and mining acquisitions during 1965 and 1966. As of the early part of 1969, acquisition activity was progressing at an annual rate of $20 billion.

The role played by federal tax considerations in motivating these transactions was publicly noted both by the outgoing and incoming administrations and by financial commentators. Testifying before the Ways and Means Committee, Dr. Willard Mueller of the Federal Trade Commission (FTC) called attention to an address by a "public relations official" made in November, 1968, reflecting, in Dr. Mueller's view, "the enthusiasm which debt-equity switching has generated in some financial circles.""
Representative John Byrnes, senior Republican on the House Ways and Means Committee, directed the Committee's attention to an article, “The Merger Movement Rides High,” appearing in Fortune magazine, which dealt with the subject of “audacious acquirers” and emphasized the extent to which federal tax laws subsidize acquisitions. The retiring Commissioner of Internal Revenue took issue with the validity of the rationale supporting the nonrecognition rules respecting mergers.

Concern with the problem was also expressed by Chairman Hamer H. Budge of the Securities and Exchange Commission (SEC) in testimony before the House Committee on Interstate and Foreign Commerce where, on February 25, 1969, he stated that “another phenomenon of the current acquisition movement is the shift towards the use of debt, securities and bank loans to finance acquisitions as compared with the use of current available cash or stock of the acquiring company.” And newly appointed Assistant Attorney General, Richard W. McLaren, in a maiden speech before the National Industrial Conference Board on March 6, 1969, warned that he had “serious concern over the severe human and economic dislocations which are resulting from the current tax-propelled merger mania.”

Not without significance is the fact that on January 29, 1969 a prospectus was issued describing a proposed tender offer of subordinated debentures and warrants by an issuing company which accompanied the offer with a statement, inter alia, that “based on the Pro Forma Statement of Earnings (Loss) of [the acquiring corporation alone, the issuer] could not meet the interest requirements on the debentures out of earnings.”

is a cost of doing business for tax purposes. Each $3 he pays out cost him only $1.50 [after taxes]. So he’s taking in $1.85 in dividends after taxes and paying out $1.50 after taxes. Thus for every share he gets in his tender he makes 35 cents. He can afford to run his printing presses overtime creating funny money by the truckload.

Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess., pt. 7, at 2419 (1969) [hereinafter cited as HEARINGS].

Suppose the stock of a rather languid company is selling at $70 a share and paying $4. Comes a raider offering a $90 convertible debenture paying $6, plus maybe some warrants to sweeten the pot. The raider times his offer so that the dividends . . . then become intercompany dividends, which are 85 percent tax deductible; and the raider thus keeps about $3.40 of the $4. What is more, the $6 interest on the debentures he offers is a business expense and tax deductible, and so costs less than $3. The raider, thanks to federal tax laws, makes more than 40 cents on each share tendered him, often more than enough to pay all expenses.


One reason for the increasing use of debt financing may be the fact that the tax laws appear to encourage this method of financing take-overs. Chairman Budge added that: I am fully aware that the problem of closing possible tax loopholes is an intricate one. Nevertheless, we cannot help but note the extent to which tax considerations affect the techniques of corporate combinations. One important factor is the impact of the deduction allowed for interest payments.

Remarks by Richard W. McLaren, Ass't Att'y Gen., Antitrust Div., United States Dep't of Justice, before the National Industrial Conference Board, March 6, 1969.

prospectus also stated that the offering company had received an opinion from its counsel that although stockholders of the selling company would realize gain or loss for federal income tax purposes, that a stockholder in whose hands the shares to be exchanged constituted capital assets and who realized gain by reason of acceptance of the offer could elect to "postpone such gain and to report it on the installment basis under section 453 of the Internal Revenue Code." Other eminent counsel had opined similarly with respect to installment treatment.

Viewed in the foregoing light, Chairman Mills' introduction of H.R. 7489 (accompanied by a press statement in which the Chairman "questioned whether it was good either for the shareholders or for the economy as a whole for these conglomerate mergers to occur"), if unusual, could hardly be called surprising. Hearings on this proposal not unexpectedly produced testimony from the SEC, the FTC and the Justice Department supporting the concept of the legislation. Other witnesses from the business community, concerned with "take-overs" and the issuance of complicated securities attending such combinations, also supported the legislation.

The tax effects to the acquiring corporation and the selling shareholders involve a group of issues which, while involving some uncertainty prior to the introduction of H.R. 7489, now are the subject of special treatment in amendments to the Code made in the Tax Reform Act of 1969.

These issues may be summarized as follows.

1. Interest

The threshold question which concerns any transaction utilizing subordinated debentures relates to their characterization as debt, allowing the issuer to deduct periodic payments from gross income as "interest."

While it is believed that in most instances of debt-financed acquisitions effected in recent years, counsel have advised, formally or informally (and/or the principals have assumed), that payments denominated as interest were deductible, in some instances rulings from the Internal Revenue Service were sought. Favorable rulings would issue in those situations in which, on the basis of a pro-forma consolidation of the acquired and acquiring

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16 *Id.* at 7-8.
18 *House Committee on Ways and Means* Release, *supra* note 2. "The financing is top heavy with debt securities. [This] will have a serious impact on government revenues by converting what formerly were non-deductible dividend payments into tax deductible interest payments." *Id.*
19 See *Hearings at* 2363 *passim.* The hearings were held under the heading "Tax Provisions Relating to Corporate Mergers" and thus were not directly limited to the debt-equity switching problem.
20 Objections to the proposal were reflected in statements filed with the Ways and Means Committee which pointed out, *inter alia*, that the ability of small companies without access to the stock market to issue debt would be restricted. *Hearings at* 2504-05.
21 I.R.C. § 163.
entities, sufficient criteria, drawn from the decided cases, established the existence of a debtor-creditor relationship. Where the issuing company's shares were publicly held, the Service's chief concern centered around the ability of the surviving corporation to meet "coverage" tests, comparable to those now reflected in section 279, respecting adequate equity in relation to debt and adequate earnings in relation to interest costs.

In perceptively analyzing the area in terms of the parties' negotiating relationship, Commissioner of Internal Revenue Randolph W. Thrower has suggested that shareholders who sell a successful going concern in exchange for convertible debentures are bargaining for "the right through conversion to participate in future growth" and that therefore such persons "may well be more interested in cashing in on the stock rise than in collecting a debt." By framing the issue in terms of subjective intent, the Commissioner has sharpened the relevancy of considerations heretofore largely considered in the context of closely held corporations. Among the other elements present in the "general circumstances" referred to by the Commissioner (which may not be present in every debt-financed acquisition) were: where a debenture issue was of such magnitude that the issuing company could not itself have marketed the debentures for cash; and circumstances where the historical earnings of an acquired corporation (often already indebted to third persons) and the issuing corporation, even when combined, may not support the debt service required by the debentures, unless "extremely profitable" "substantial growth" results from the business amalgamation.

Except in those situations in which closing agreements were entered into or in which favorable rulings have issued on the basis of unchanged and fully disclosed facts which are honored as a matter of administrative policy, the Treasury remains in a posture to challenge the deduction for interest in an appropriate situation. Whether this issue, if in fact raised by the Government, particularly in the provocative case discussed by Commissioner Thrower, can be successfully maintained remains to be determined.

A successful assault by the Treasury upon characterization of debentures used to finance an acquisition may, of course, spawn an array of altered tax effects at both the level of the holder of the instrument and the corporation. If the debenture is regarded as equity, its characterization as "preferred" stock would appear most probable. While ostensibly the preferred would be regarded as nonvoting because the debenture does not

24 Remarks by Randolph W. Thrower, Comm'r of Internal Revenue, before the American Bar Association National Institute, Oct. 23, 1969.
25 See, e.g., W.H. Truschel, 29 T.C. 433 (1957), where shareholders of the acquired corporation received notes and bonds of the acquiring corporation in exchange for their stock. The Revenue Service unsuccessfully argued that the acquiring corporation was so thinly capitalized that the bonds were, in substance, equity, resulting in a nontaxable reorganization. See also Estate of Ernest G. Howes, 30 T.C. 909 (1958), aff'd sub nom., Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959); Ralph M. Heintz, 25 T.C. 132 (1955), not acquiesced in, 1958-1 Cum. Bull. 7.
possess voting rights, the holder (of a convertible debenture or a debenture with warrants attached) is in a position to become a voting shareholder through the exercise of his conversion rights or the "put" of his warrant. Normally, in both instances, such rights fully exist without the payment of additional consideration, since surrender of the debentures constitutes an exercise of the conversion right or (in many cases) payment of all or part of the warrant price. Indeed, it is the element of unrelinquished proprietary presence (reflected in the inchoate right to vote) which, if of sufficient strength to vitiate the debtor-creditor relationship of the parties, should, in turn, suggest a continuity of ownership possessing "reorganization" indicia.

Whether the statutory requirements of section 368 are also satisfied is, of course, quite another matter, the answers to which may well depend upon local law and the transactional form. Where a statutory merger constitutes the vehicle whereby the issuing company directly accomplished the acquisition or where the issuing company formed (or used) a subsidiary for that purpose (as the acquiring entity into which the acquired company was merged), the requisite exchange of stock or securities has taken place and section 368(a)(1)(A) or (a)(2)(D) presumably applies. And for the reasons noted respecting the assumed failure of the sellers to convert their position from shareholder to creditor status, the requisite continuity of ownership has been maintained. Although sellers who receive warrants would be treated as having received "boot" for purposes of section 356, its presence would not be expected to destroy the reorganization since the value of the boot would have been limited because of attempted compliance with the installment election provisions.26

If, on the other hand, the issuing corporation's "plan" consisted of a tender of its securities for shares of the company to be acquired, it is unlikely that a reorganization could be regarded as having occurred. In that instance, the exchanging shareholders' lack of present right to vote and the presence of the warrant result in failure to satisfy the "solely for voting stock" requirement of both a "B" and "C" reorganization.27

It is difficult to predict the direction which a governmental contention may take respecting the above-described points. Although reorganization characterization may exonerate most shareholder level gain, it could also cause a denial of a substantial step-up in basis at the corporate level (assuming the issuing company had desired to, and did, appropriately liquidate the

26 Under section 453(b)(2), the value of the warrants may not exceed 30 percent of the selling price if the installment method is to be elected. Boot can be received in a statutory merger, under present Service policy, in an aggregate amount not exceeding 50 percent of the value of the consideration received. See Rev. Proc. 66-34, 1966-2 Cum. Bull. 1232.

acquired entity).\textsuperscript{28} Revenues derivable from the reduction of the basis may be more readily available, in practical audit terms, than those which would result from recognized gain at the level of the multitudinous shareholders often involved in the acquisition of the shares of a widely held concern.

However the transaction is characterized at the corporate level, it would also appear that the amount payable periodically with respect to the debentures, if not deductible as interest, would be treated as nondeductible dividends on preferred stock.\textsuperscript{29}

At the shareholder level, characterization of the debentures as equity rather than debt may generate equal, if not greater, adverse tax consequences. While treatment of the acquisition as a reorganization may operate to defer full recognition of gain to the shareholders (through a reduction in basis),\textsuperscript{30} the warrants or other property received in the acquisition will be considered boot and may be taxable as a dividend.\textsuperscript{31} Moreover, there is some exposure to the risk that repayment of the debentures by the acquiring corporation would also be treated as a dividend distribution unless the redemption falls within the "safe-harbors" provided by section 302.\textsuperscript{32}

2. \textit{Original Issue Discount}

Pre-1970 questions respecting original issue discount may be attributed to the inevitable lag between language of a statute, intended to meet one set of observed facts, and the more precise language later found necessary to cope with a variant of those facts, existing later in differing and more complex circumstances.

Drafted to equate the tax treatment of bond sales with their retirement for cash,\textsuperscript{33} section 1232 did not, in all probability, contemplate the treatment

\begin{footnotesize}
\textsuperscript{28} I.R.C. \S 362(b).
\textsuperscript{29} See, e.g., R.C. Owen Co. v. Commissioner, 351 F.2d 410 (6th Cir. 1965), \textit{cert. denied}, 383 U.S. 967 (1966); Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964).
\textsuperscript{30} I.R.C. \S\S 354(a)(1), 358(a).
\textsuperscript{31} Under section 356(a)(2), the payment of boot to shareholders in connection with a reorganization which "has the effect of the distribution of a dividend" is taxable at ordinary income rates to the extent of gain realized in the transaction, but not in excess of each stockholder's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." Where the distribution to shareholders is pro rata, it will be deemed to have the effect of a dividend. See Bazley v. Commissioner, 331 U.S. 737 (1947); Commissioner v. Estate of Bedford, 325 U.S. 283 (1945). Moreover, while the phrase "of a corporation" in section 356(a)(2) generally has been interpreted to refer to the acquired corporation, one court utilized the earnings and profits of both the acquired and the acquiring corporations to test whether boot distributions were taxable as dividends. \textit{Compare} James Armour, Inc., 43 T.C. 295 (1964) \textit{with} Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), \textit{cert. denied}, 386 U.S. 1022 (1967).
\textsuperscript{32} See Harlan v. United States, 409 F.2d 904 (5th Cir. 1969); Ambassador Apts., Inc., v. Commissioner, 406 F.2d 288 (2d Cir. 1969); Burr Oak Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), \textit{cert. denied}, 385 U.S. 1007 (1967); Fellinger v. United States, 363 F.2d 826 (6th Cir. 1966).
\textsuperscript{33} See I.R.C. \S 117(f) (1939), the predecessor of I.R.C. \S 1232(a)(1).
\end{footnotesize}
of bonds initially issued at a discount, whether for money or for other property. In general, section 1232, as enacted in 1954, contemplated issuance of bonds for cash; the possibility that debt would be issued as consideration for the acquisition of property having a value less than the bonds’ face amount does not clearly appear to have been considered by the draftsmen. Even more remote was the possible generation of such an original issue discount where the acquisition of the sellers’ stock or assets was effected through use of convertible bonds or some more exotic combination of debt securities with warrants or other rights to acquire common shares.

Such, however, were the points which came to light as counsel considered the tax effects of debt-financed acquisitions. Also pertinent was the interplay of the revenue effect between the issuing company and the holder. Prior to 1970, a gap in the reporting of income generated by the issuance of bonds at a discount existed due to the issuer’s deduction of a portion of the discount under long-settled regulations, whereas a cash basis holder did not include any portion of such discount in income until the bonds were sold or retired.

In the case of convertible bonds, regulations applicable to the holder under section 1232, originally silent on the point, ultimately provided that value attributable to the conversion feature constitutes part of issue price, thus restricting both the amount deducted by the issuer and the amount included in the holder’s income. Where bonds are issued with warrants, the regulations apply a rule allocating cost to the warrants (in terms of the relative fair market value of the bonds and warrants). If stock or assets of a business were acquired in exchange for convertible bonds or bonds with warrants, the above points were complicated by the additional question as to the extent and manner in which discount arose when such properties, rather than money, constituted the consideration

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38 Treas. Reg. § 1.61-12(c), T.D. 6984, 1969 INT. REV. BULL. No. 6, at 7-8. I.R.C. § 1232(a)(3), as amended by § 413(a) of the Tax Reform Act of 1969, now requires ratable inclusion of original issue discount in the gross income of the holder. The issuer must annually supply information to the holder and the Treasury regarding the amount of original issue discount so includible. See I.R.C. § 6049.
40 Treas. Reg. § 1.1232-3(b)(2)(i), T.D. 6984, 1969 INT. REV. BULL. No. 6, at 11. The amendments to the section 1232 regulations were originally proposed in August 1964, but were withdrawn and new proposals were substituted in September 1968 (33 Fed. Reg. 12,376), and were finally adopted in T.D. 6984, 1969 INT. REV. BULL. No. 6, at 7 (Dec. 23, 1968).
for issuance of the securities. It is not surprising, therefore, to find legislative refinements proposed (generating original issue discount in this case) when the opportunity for revision appeared with the introduction of H.R. 13270.42

3. “Original Issue” Premium

Where debentures issued to acquire stock or business assets trade (at or about the closing date of the transaction) at a premium (or if it otherwise appears that the fair market value of the assets of the acquired business exceeds the face amount of the instruments), the possibility exists that the Treasury will assert that the bonds were issued at a premium. In such event, the converse of the situation which obtains in connection with bonds issued for property at a discount arises; the issuing corporation would be required (under regulations at the close of 1968) to include the amount of the premium in income to be prorated or amortized over the life of the instrument.43 If convertible bonds were utilized to effect the acquisition, the regulations exclude any part of the premium determined to be “attributable to a conversion feature.”44 If the debentures are issued as part of an investment unit which encompasses warrants, the part of the consideration referable to the warrants is similarly not treated as part of the premium.45

Whether a premium will exist upon issuance of a convertible debenture or a debenture accompanied by a warrant may largely be a function of the difficult determination of fair market value of the acquired assets in relation to the face amount of the debenture, and the conversion feature, or the warrant, as the case may be. The fact that a determinable amount of securities trade, at or about the closing date of the transaction, for an ascertainable price, certainly indicates the market’s evaluation of the transaction. On the other hand, it seems difficult to ignore the impact of general conditions upon trading prices during the same period. Questions

42 Tax Reform Act § 413(b) amends IRC § 1232(b)(2) in order to adopt the rule set forth in Treas. Reg. § 1.1232-3(b)(2)(ii), relating to the allocation of the purchase price between the debt and the warrants. The amendment further provides that:

in the case of a bond or other evidence of indebtedness, or an investment unit [consisting of an option or other security issued together] . . . which is issued for property and which — (A) is part of an issue a portion of which is traded on an established securities market, or (B) is issued for stock or securities which are traded on an established securities market, the issue price of such bond or other evidence of indebtedness or other investment unit, as the case may be, shall be the fair market value of such property.


44 See id. § 1.61-12(c)(2), T.D. 6984, 1969 INT. REV. BULL. No. 6, at 10, which defines bond premium as “the excess of the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3) over the amount payable at maturity (or in the case of callable bond, at the earlier call date).” Treas. Reg. § 1.1232-3(b)(2) provides that where a warrant (i.e., “an option”) constitutes part of the investment unit “the issue price of the obligation includes only that portion of the initial offering price . . . properly allocable to the obligation. . . .”
of "blockage" must also be considered, since it would seem unreasonable to value the entire going concern by reference to the trading prices of what, in most instances, would represent a very limited portion of the total number of securities which are issued.\textsuperscript{46} Finally, an independent appraisal of the business assets may well suggest a relationship between the face amount of the debentures and the conversion feature or the warrant which differs from (or should be taken into account in determining) the value of the stock or assets acquired in relation to the face amount of the debentures.

There exists also the question of whether a premium can arise upon the issuance of securities for property, much in terms of the comparable issues considered to exist prior to the 1969 legislation respecting original issue discount. Where the bonds are convertible or include warrants as part of the investment unit, and the value attributable to the conversion privilege or the warrant is ascertainable, and that amount plus the face amount of the debenture does not equal the total trading price\textsuperscript{47} of the security or the unit, serious possibility exists that premium is present. This question, both before and after the 1969 legislation, is additionally complicated by the distinctions drawn in that legislation between readily traded securities, where original issue discount can exist, and other securities (including those issued in reorganizations), where it cannot exist.\textsuperscript{48} The absence of Congressional action could be taken to suggest the nonexistence of premium in any case in which property is acquired, since, had Congress so chosen, the rules now applicable in connection with original issue discount under section 1232 could have been, but were not, applied to "original issue" premium.

4. Repurchase Premium

Congress did, however, act to settle questions relating to the tax treatment of the premium paid by an issuer upon repurchase of its convertible debt.

An issuer, repurchasing its convertible debt, may pay a premium to the holder to reflect the fact that the debt carries an interest rate higher than that prevailing under then current market conditions. The repurchase premium, as compensation to the investor for his loss of future interest, is deductible by the purchaser (issuer) and includible in the gross income of the seller (holder).\textsuperscript{49} Premiums paid by the issuer, however, may not reflect lower interest rates alone. Rather, all or a portion of the premium may be

\textsuperscript{46} See Champion v. Commissioner, 303 F.2d 887 (5th Cir. 1962), rev'd 19 CCH Tax Ct. Mem. 253 (1960); Sensenbrenner v. Commissioner, 134 F.2d 883 (7th Cir. 1943); Helvering v. Safe Deposit & Trust Co., 95 F.2d 806 (4th Cir. 1938); Rogers v. Strong, 72 F.2d 455 (3d Cir. 1934); Treas. Reg. § 20.2031-2(e) (1958). But see Mott v. Commissioner, 139 F.2d 317 (6th Cir. 1945).

\textsuperscript{47} Or value, however otherwise ascertained.

\textsuperscript{48} I.R.C. § 1232(b)(2), as amended Tax Reform Act § 413(b).

attributable to the value of the conversion feature. Since the cost incurred by the corporation in reacquiring its own stock is not deductible,50 the repurchase premium attributable to the value of the conversion feature should not be a deductible expense.

In Roberts & Porter, Inc. v. Commissioner,51 however, the court of appeals for the Seventh Circuit permitted the taxpayer to deduct a $77,000 premium paid on repurchase of its convertible notes. While it viewed the repurchase premium as attributable to the conversion feature, it held the premium deductible since “[t]here is no provision in the Code or Regulations which organizes allocation of the total purchase price to the value of the conversion feature.”52 The decision placed the Treasury in a position where it could be whipsawed upon a repurchase of convertible debt. Indeed, the corporation now would be likely to deduct any premium paid upon repurchase. The holder, on the other hand, could assert the premium was attributable solely to the conversion feature of the bond and thus could treat as premium an item of capital gain under section 1232.

The Service therefore announced that it would not follow Roberts & Porter,53 and only amounts attributable to the cost of borrowing money would be deductible as repurchase premium. Moreover, 1968 amendments to the regulations provide that the issuer of convertible debt which pays a premium upon repurchase may deduct only one year’s interest, “except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate, that an amount in excess of one year’s interest does not include any amount attributable to the conversion feature.”54

Nevertheless, in view of the uncertainty created by Roberts & Porter, the Treasury recommended as part of its tax reform proposals that the corporation’s deduction for bond repurchase premium be limited to an amount not in excess of a normal call premium for corporate indebtedness.55

5. Installment Method

Among the most intriguing issues which arose in the several years preceding introduction of H.R. 7489 was the possibility that a shareholder

50 I.R.C. § 311(a).
52 The court referred to the 1950 amendment to section 125 of the 1939 Code (now section 171 of the 1954 Code) which denies to the holder of a bond the right to amortize that portion of the original issue price attributable to the conversion feature. But Congress would not, then or later, eliminate or limit the deduction by an issuing corporation of such part of any premium, attributable to a conversion feature, which the corporation may have paid when repurchasing its own bonds. If the situation represents a breach in our revenue wall, its repair must be effected by legislative action rather than by judicial interpretation. Id. at 747-48.
55 Hearings at 5481 (statement of Edward S. Cohen, Ass’t Sec’y of the Treasury for Tax Policy).
exchanging shares for debentures (whether or not convertible and whether or not with warrants attached) could utilize the installment method of reporting the gain realized by him on the exchange. This issue had been presented to the Internal Revenue Service for ruling at least as early as 1965. Unresolved questions included: whether the installment provisions were intended to apply to marketable instruments; whether the requisite selling price could be ascertained in the case of a convertible debenture; if the debenture did not provide for interim payments prior to maturity, whether an installment obligation in fact existed; if an installment obligation did exist in the case of a convertible debenture, whether gain was realized at the time of conversion; if gain was realized, whether the amount to be recognized is limited by the issue price or includes a greater fair market value; if the acquisition was effected under local law by statutory merger (which would probably be fully taxable because of lack of continuity of interest), whether installment treatment would be unavailable in any event because a constructive liquidation in the selling shareholders' hands, prior to the transfer of the assets, is deemed to have occurred.

Despite the foregoing uncertainties, highly responsible counsel have issued opinions concluding that the installment method may be elected (assuming the acquisition was effected for stock and not in a statutory merger and that the other conditions of section 453 are met). To insure that the down payment does not exceed 30 percent of the selling price, efforts were made to establish that the value of warrants accompanying the debentures (or that the value attributable to the conversion feature) did not exceed 30 percent of the face amount of the obligation. To establish that the obligation constituted an installment instrument, its terms provided for two payments (often very near maturity and very minimal in amount, such as 5 percent of face). Counsels' opinions also took the view that although income arises upon conversion, no effect, at that point, was to be given to the increment in value, if any, in excess of face amount.

No attempt will be made here to evaluate the validity of the foregoing views. The Government's concern respecting the possibility that the courts would support counsel's view (or at least that the area would have remained permanently unsettled) is reflected in the legislation first initiated through H.R. 7489.

The stakes involved respecting this issue were considerable, both in terms of revenue effect and, perhaps more importantly, vis-à-vis the general taxing pattern of acquisition transactions. Basic to these is the concept that the issuance of debt instruments as part of a corporate acquisition constitutes

58 See, e.g., Crane Co., Offer of Exchange to Holders of Common Stock of Westinghouse Air Brake Co. 6-7 (Apr. 8, 1968); Tenneco, Inc., Notice of Special Meeting of Shareholders 3-5 (July 16, 1969).
an event for the recognition of gain. A valid installment election serves to defer recognition of gain. Moreover, if the holder of the instrument were elderly and the maturity date (and/or the second payment date) were set sufficiently in the future, his death could be anticipated before any tax became due. While income in respect of a decedent would arise at the holder's death, the income tax deduction available to the estate could approach, equal or exceed the benefits to be derived from a date-of-death basis available to the seller had he held the initial shares for exchange in a nontaxable transaction. Obviously, therefore, an acquisition program which contemplated the issuance of debt and the seller's election of the installment method gave the seller, in large measure, the benefits of a nontaxable reorganization, yet allowed the buyer to receive the leverage and Income tax benefits accruing from the interest deduction, plus, if financially beneficial, a possible stepped-up basis were liquidation of the acquired company undertaken.

II. H.R. 7489

As introduced H.R. 7489 would have added section 277 to the Code, disallowing the deduction for interest if the following circumstances had

59 Under section 691(a)(4), an amount equal to the excess of face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2)) is considered income in respect of a decedent. The decedent's estate or heirs must include in gross income, when received, the same proportion of any installment payment as would be includible in the decedent's gross income if he had lived and received such payment. Treas. Reg. § 1.691(a)-5. Death is not an occasion for the acceleration of gain inherent in an installment obligation. Treas. Reg. § 1.453-9(e) (1958).

60 The recipient of income in respect of a decedent (I.R.D.) is entitled, under § 691(c), to deduct the portion of the federal estate taxes attributable to the I.R.D. against such income. An estate's realization of I.R.D. derived from an installment obligation may be advantageous since a substantial portion of each installment payment may consist of long-term capital gains. The full amount of the gain is utilized in determining the § 691(c) deduction for estate taxes, but not more than 50 percent of such gain is subject to such tax as I.R.D. in the hands of the recipient. Rev. Rul. 481, 1955-2 CUM. BULL. 279. Conceivably, the excess § 691(c) deduction generated by an installment sale could produce a greater tax benefit than the forgiveness of capital gains at death if no installment sale had occurred.

61 The full text of H.R. 7489, supra, is as follows:

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Relating to the tax treatment of certain indebtedness incurred by corporations in acquiring stock of other corporations.
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occurred: (1) one corporation had acquired stock of another corporation; (2) more than 35 percent of the consideration consisted of debt of, or "other property attributable to borrowing by," the acquiring corporation. The amount of the disallowance varied directly with the percentage of the consideration issued as debt. If 35 percent or less of such consideration consisted of debt, then section 277 would not have applied.

Because certain of the points raised in relation to H.R. 7489 are dealt with, or are inherent in, section 279 as finally enacted, it is appropriate to identify the areas of concern which first appeared in Chairman Mills' proposal. No portion of the language of H.R. 7489 relates specifically to "mergers," "conglomerate" or otherwise. And although a "plan" of acquisition was required, the interest deduction could have been disallowed under
that Bill whether or not sufficient stock was obtained under such plan to effect a corporate combination.

Further, H.R. 7489 did not differentiate between stock acquisitions which are "friendly" and those which constitute the "surprise take-overs," referred to by Chairman Mills in his press statement. Nor did it differentiate between the "highly speculative" securities, mentioned in the press announcement, and bonds of impeccable quality. Unlike section 279, H.R. 7489 did not cover asset acquisitions. While the reasons for this position are not expressed, it would appear that the Chairman's interest was centered on the typical take-over bid which involved a tender offer for shares rather than a statutory merger (which required a negotiated agreement and probably deprived the sellers of any attempted installment election).

H.R. 7489, however, clearly contemplated an interest disallowance where cash was used to effect the stock purchase when the cash was acquired from the proceeds of a loan effected for that purpose. Indeed, the phrase "attributable to borrowing," as used in the Bill, appeared sufficiently broad to empower the Internal Revenue Service to relate a portion of an acquiring company's general debt structure to stock acquisitions.

Because of the breadth of its language, H.R. 7489 potentially swept within its scope the following: acquisitions of shares of a closely held corporation, whether a ready market existed for such shares or not; acquisitions of shares of "related" corporations, including those owned by the same or a related shareholder as well as in an affiliated group; acquisitions of shares as part of a "primary" offering of securities where the seller of the shares is the issuing corporation; acquisitions of shares of a foreign subsidiary or affiliate where the foreign corporation derives its earnings abroad and is established to comply with the U.S. foreign direct investment program. Moreover, no distinction was made between the acquisition of voting or nonvoting shares.

H.R. 7489 also dealt with the installment method problem. It withdrew from treatment as "an evidence of indebtedness of the purchaser" a bond or debenture issued by a corporation or governmental entity "with interest coupons or in registered form." The important, but essentially technical, refinements which were added to the statute's final form cannot obscure the fact that this single sentence, proposed to be made effective concurrently with the Bill's introduction, effectively eliminated the use (or attempted use) of the installment method provisions as a means of deferring gain in debt-

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62 See House Ways and Means Committee Release, supra note 2.
64 Compare H.R. 7489 § 1 with I.R.C. § 265(2). See also Wisconsin Cheeseman, Inc. v United States, 388 F.2d 420 (7th Cir. 1968); Illinois Terminal R.R. v. United States, 375 F.2d 1016 (Ct. of Claims 1967); Bernard H. Jacobson, 28 T.C. 579 (1957).
65 H.R. 7489 § 2; thus a debenture issued in a corporate acquisition would be treated as an immediate payment, subject to the 30 percent rule of I.R.C. § 453(b)(2)(A).
financed acquisitions. Moreover, H.R. 7489 provided that, in the case of installment sales occurring before the proposed effective date, the determination of whether debentures of the type described in the Bill qualified as installment obligations "shall be made without inferences drawn from the fact that the amendment . . . does not apply to such sales or dispositions." That the provision did not survive in either the statute as finally enacted or in the Committee Reports suggests that the courts are free to construe section 453 with "insight" unencumbered by the 1969 legislation.

III. THE TAX REFORM ACT OF 1969

By availing itself of the fuller array of facts presented at the hearings, and utilizing the Internal Revenues Service's experience in connection with regulations respecting original issue discount (including the Treasury tax policy staff's expertise in the financial market place), the Ways and Means Committee was in a position to report out amendments which dealt less abrasively with the problems heretofore discussed. In consequence, a comprehensive statutory pattern now emerges which treats the deductibility of the interest, the amortization of debt discount, and the deductibility of "repurchase" premium at the issuing company level. Rules are also provided for selling shareholders respecting the nonavailability of installment treatment and the degree of inclusion in income of original issue discount.

This portion of this paper seeks to describe substance and interplay of these provisions.

1. Disallowance of Interest Paid on Corporate Acquisition Indebtedness

The principal provision of the 1969 legislation pertinent to the subject matter of this paper is section 279. This section superimposes upon section 163 a specific disallowance of the deduction for interest amounts exceeding $5 million paid or incurred during the taxable year with respect to

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66 H.R. 7489 § 2. The Government was well aware of the various documents filed with the Securities and Exchange Commission, which were publicly available, indicating that legal opinions had been rendered to the effect that recipients of marketable debentures issued in a corporate acquisition could elect the installment method. See H.R. REP. No. 413, supra note 7, at 107; S. REP. No. 552, 91st Cong., 1st Sess. 144 (1969) [hereinafter cited as S. REP. No. 552].


68 In addition to provisions limiting the deductibility of interest arising in connection with debt-financed acquisitions and the availability of the installment election in such cases, the House Bill also dealt with original issue discount and deduction of bond premium upon repurchase. The substance of the House Bill was adopted and refined by the Senate, and a new provision was added dealing specifically with the debt-equity problem. Tax Reform Act § 411, I.R.C. § 279.

69 The $5 million limitation, however, is reduced by the amount of interest paid or incurred on obligations issued after December 31, 1967, to finance corporate acquisitions, but which do not fall within the definition of "corporate acquisition indebtedness." I.R.C. § 279(a)(2). Such obligations include those used to finance acquisitions of foreign corporations and those not subject to disallowance of interest by reason of the 3 year rule and 5 percent stock rule.
"debt" issued as consideration for the acquisition of corporate shares or assets where, as of a specified date, the following conditions are met.

(a) If stock is acquired, the issuing company owns (at the close of the year in which the acquisition debt is issued) more than 5 percent of the total voting power of the acquired corporation. Excluded from this rule is stock of existing controlled subsidiaries.

(b) If assets are acquired, the acquisition encompasses a plan under which at least two-thirds (measured by value) of all of the corporate "operating assets" (excluding money) are obtained by the issuing company.

(c) The obligation of the issuing corporation is, or becomes, subordinated to its trade creditors generally or is "expressly subordinated" in right of payment to "any substantial amount" of such corporation's unsecured debt.

(d) The debt is "directly or indirectly" convertible into the issuing corporation's stock or is issued as part of an investment unit or "other arrangement" which includes, in addition to the debt, a warrant or option to acquire "directly or indirectly" the issuing corporation's stock.

(e) As of the last day of a taxable year of issuance, either the issuing corporation's "ratio of debt to equity" exceeds 2 to 1 or its "projected earnings" do not exceed three times the annual interest to be paid or incurred.

Within the framework of these principal rules, certain limitations and problems of construction may be noted.

a. $5 Million Limitation

As an apparent substitute for the vertical limitation of H.R. 7489 on the amount of debt which may be issued in any one acquisition (i.e., "35 percent of total consideration"), Congress has adopted a $5 million horizontal limitation on interest deductible on all acquisition debt. So structured, a corporation may issue and carry on today's market approximately $50 to $60 million of subordinated debt without concern under section 279 for the

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70 But see I.R.C. § 285, which specifically authorizes the Commissioner to publish guidelines for determining whether a corporate obligation is, in fact, "debt." Moreover, section 279(j) provides that "No inference shall be drawn from any provision in this section that any instrument * * * represents an obligation or indebtedness of [the] issuer in applying any other provision of this title."

71 See I.R.C. § 279(c)(1), (d).
72 Id. § 279(d)(5).
73 Id. § 279(e).
74 Id. § 279(b)(1)(B).
75 Id. § 279(b)(2). The unsecured debt with respect to which the subordination of the corporate acquisition indebtedness is measured may be subsequently issued. Id. § 279(b)(2)(B).
76 Id. § 279(b)(3).
77 Id. § 279(b)(4).
78 There is omitted from this discussion the narrow rules of section 279 relating to banks and finance companies (Id. § 279(c)(5)), acquisitions of certain foreign corporations (Id. § 279(f)), and certain transitional provisions (Id. § 279(i)).
deductibility of the interest. A "large" corporation may therefore make a single reasonably substantial acquisition or a series of smaller ones utilizing subordinated debt, whereas a small corporation, which may be closely held and could be otherwise most troubled by the inhibitions of this provision (because of a more expectable need for subordinated debt, for example), need have no concern for it.

In this respect, the operation of the new statute would appear to be most salutary; and a mechanism seems to have been created whereby the large "paper" transactions, the stifling of which was the essential objective of H.R. 7489, have been proscribed without undue interference with other business combinations which do not involve major "take-overs" (whether friendly or hostile) of large corporate enterprises.

b. Stock and Assets

The less than 5 percent rule of section 279(d)(5) permits what may be termed de minimis acquisitions of shares. At the same time, however, the statute is effective in the 5 to 50 percent range, before the acquirer reaches the 51 percent level, preventing the purchase of significant blocks of stock with subordinated debt prior to, but as part of, a plan under which a tender offer is made for a controlling percentage (whether absolute or "working") of a "target" company's shares.

It may also be observed that section 279 applies whether the acquisition is "friendly" or "hostile." Further, as the section would apply only if the requisite 5 percent amount is acquired with respect to "the total combined power of all classes of stock entitled to vote," no limit would apply to the acquisition of nonvoting common or preferred shares. Moreover, so long as 5 percent of the total voting power is not acquired (assuming the 5 percent rule is not applied separately to each class of voting stock), the acquisition of a separate, bona fide class of voting preferred stock, for example, should not be subject to the provision.

Because a sale of assets not in the ordinary course of business normally necessitates approval of a majority of a selling corporation's board of directors (as well as a stated percentage of its shares), a hostile assets acquisition would be a rare, if not an impossible, event. It is perhaps for this reason that section 279 is inapplicable unless two-thirds of the company's operating properties are thus acquired.

On the other hand, the statute's exclusion of cash and other non-operating assets from the test of whether two-thirds of the operating assets have been acquired was incorporated into the legislation in order to prevent the avoidance of the provision through the contribution to the corporation of liquid items, or, even where the assets were not so contributed, where

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79 Assuming an average interest cost of 8-9 percent.
80 See S. REP. No. 552, at 143. Presumably, however, a rare case could be found where less than 5 percent of the total voting stock constituted working control of a corporation.
81 I.R.C. § 279(d)(5).
the nature of the corporation's business is such that a "large proportion" of its assets "consisted of cash or nonoperating properties."  

A somewhat more difficult question is presented with respect to the measurement of the value of assets for the two-thirds requirement. If gross value is used (i.e., assets without regard to the acquired corporation's liabilities), the requirement can be avoided more readily than if the test were applied on a net basis (for example, if the percentage were to be applied to the portion of the operating assets not acquired, directly or indirectly, with borrowed funds). That the Congress intended the stricter (net value) application of the test would, notwithstanding, appear unlikely. Since the gravamen of the statute is the acquisition of a corporation as a going concern, it should make no difference whether part of the requisite two-thirds was initially obtained by the acquired corporation with borrowed funds. Such an approach, of course, assumes that these assets were needed in the business. If they were not so needed, but were acquired with borrowed funds for the purpose of structuring a transaction to escape section 279, the two-thirds test would appear to be properly measured against the assets on hand when the "plan" for the acquisition was first formulated by the acquiring corporation.

To underscore the fact that the asset acquisition test is to be construed in a relatively liberal manner, the Senate Finance Committee Report also makes clear that assets which presumably have been used in the corporation's business, but are "temporarily not actually used," will "retain" their operating character.  

Because a partial asset purchase as a step in an over-all business acquisition plan would be an unlikely possibility, it was not felt necessary to extend the statute to such events. Any other rule could cast a cloud over any asset acquisition directly or indirectly effected with subordinated debt (assuming the other conditions of section 279 were also present).

c. Use of Cash or Property "Attributable to" the Issuance of Corporate Acquisition Indebtedness

Surprisingly, and quite unlike H.R. 7489, section 279 contains no express prohibition against "indirect" use of corporate acquisition indebtedness. This may occur, for example, if the acquiring company first issues debt for cash and thereafter utilizes the funds to effect the acquisition of stock or assets. To reach the same result, but perhaps to avoid a statutory implication that a wide-ranging attribution requirement is in order, the reference to indirect use of cash is relegated to the Committee Reports:

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82 S. Rep. No. 552, at 139.
83 Id. The full sentence stated that "An asset which will be used in a corporation's trade or business is to retain this status even though it is temporarily not actually used in the business." While the sentence does not refer to the question of whether the asset was used by a corporation before its current idle status, the word "retain" suggests prior use.
"The term ‘issued’ includes the giving of a note to a bank or other lender as well as the issuance of a bond or debenture."\(^8\)

Moreover, the strength of the statutory language itself, as the Committee Report indicates, should provide ample opportunity for future regulations under section 279 to cover cash purchases supported by borrowings where, in fact, subordinated acquisition debt was issued for that purpose. At the same time, however, a taxpayer is not exposed to the possibility that a pro tanto reduction of the interest deduction can be sustained in the case where a corporation has utilized subordinated debt for general purposes (under circumstances where the debt-equity ratios and the projected earnings formulae also apply), but where there is no causal relationship between the existence of the borrowing and the later purchase of shares or assets.

Where a corporation effects a cash purchase in a taxable year subsequent to a year in which subordinated debt otherwise constituting acquisition debt was issued, it would appear that the interest deduction would be disallowed not only for the later year of purchase, but also for the earlier year or years during which the debt was issued and remains outstanding. Such a result would follow from the rule requiring a determination as to the existence of acquisition debt to be made as of the last day of the taxable year in which all the conditions pertinent to the definition are present and during which the debt was issued.\(^{85}\) The fact that no acquisition of stock or assets was made in the year of issuance of the debt is not material if the purpose of issuance was "to provide consideration" for an acquisition.

d. Subordination

Although the House version of section 279 would have limited this test to obligations which were subordinated solely to the claims of trade creditors,\(^8\) the Senate added a provision, accepted by the House which applied the test to obligations which were subordinated to "any substantial" amount of unsecured debt.\(^7\) This change resulted presumably from the belief that the trade-creditor rule could be too easily avoided by issuing debentures which maintained a debt position pari passu with trade creditors, but held, under the trust indenture, a secondary position with respect to other debt.\(^8\)

e. Debt to Equity Ratio

The success of the House in maintaining the 2 to 1 ratio as the measure of the debt to equity test (over the Senate’s attempt to raise such ratio to

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\(^8\) S. REP. NO. 552, at 142.
\(^8\) I.R.C. § 279(c)(1).
\(^8\) House Version § 411(a), I.R.C. § 279(b)(2).
\(^7\) I.R.C. § 279(b)(2)(B).
\(^8\) See S. REP. NO. 552, at 139. An indenture may provide, for example, that subordinated debt ranks below "Senior Debt." Thus, subordinated debt would be subject to any post-issuance borrowing denominated Senior Debt, so that a corporation desiring to pay trade creditors could first issue Senior Debt, and with the funds thereby obtained, satisfy trade creditor, but not debenture, claims.
4 to 1) suggests a rather tight application of this rule. In this connection, it may be noted that the ratio is developed in relation to the assets' adjusted basis for determining gain rather than in relation to their value. Whether such adjusted basis (which may often be less, but could also be more, than fair market value) has been the appropriate test under the decided case involving thin capitalization is an unsettled question. The statute's utilization of the adjusted basis rule suggests a stricter application of the test (on the assumption that value will in a generally inflationary economy exceed basis as adjusted in most cases). More pragmatically, the adjusted basis approach serves to avoid difficult valuation questions. The House technical explanation establishes also that the debt-equity ratio test is also to be applied by taking into account short-term as well as long-term liabilities. Here again is evidence of a Congressional (or Congressional and/or Treasury staff) expression of a rule to prevent avoidance of the statute through use of temporary debt.

f. Relationship of "Earnings" to Interest Cost

Following in general a version of informal Internal Revenue Service ruling policy, section 279(b)(4)(B) and section 279(e)(3) permit an issuing corporation to escape the definition of acquisition debt by establishing that the annual "average" of its earnings for the three-year period preceding the issuance of the obligation represents an amount at least three times the annual interest to be paid for the years in question. Because no reduction is made for interest (paid or incurred), depreciation or amortization allowed, federal tax liabilities or dividend distributions, a fair measurement of economic earnings "coverage" with respect to the interest payments is provided.

An important set of rules prescribes the extent to which the earnings and the interest obligations of the acquired corporation are to be consolidated with the earnings and interest of the issuing corporation for purposes of applying the "projected earnings" test. Acquisition of "control," within the meaning of the reorganization definition of section 368(c),

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90 I.R.C. § 279(c)(2).
92 See H.R. REP. No. 413, supra note 7, pt. 2, at 78.
93 "Average" earnings are to be determined under regulations, which will also provide rules respecting average earnings for a period of less than a year or less than 3 years.
94 It is hoped that no distinction was intended between depreciation "allowed" and "allowable," although both words could have been explored in the statute.
95 Other than those paid by the acquired to the issuing corporation.
96 Presumably, this would be interest payments with respect to debt of the acquired corporation other than the acquisition indebtedness (which, of course, constitutes debt of the issuing corporation).
or "substantially all the properties," of the acquired corporation requires\(^98\) that the issuing corporation's earnings and interest payments be combined with those of the acquired entity in ascertaining whether the earnings and interest relationship exceeds the statutory ceiling.

Because a similar control test applies in connection with authority to file consolidated returns pursuant to section 1504 or to liquidate under section 332, the use of such 80 percent rule follows a consistent pattern. As occurs, however, with any arbitrary and mathematically prescribed standard, differences in result can arise depending upon whether such test point is, or is not met, by a degree however small. In the case of section 279, the results can be startling. If, upon a tender offer, the requisite 80 percent shares are obtained, the "coverage" provided by the acquired corporation's pre-tax earnings may be sufficient (or can be calculated to be sufficient) to enable the combined entity to gain sufficient earnings coverage to avoid the projected earnings test. On the other hand, if control is not acquired, the issuing corporation will not have the benefit of the normally profitable acquired corporation's earnings. While such a consequence may cause the instrument to be characterized as acquisition debt, it is also to be observed that, if and when control is acquired, the combined results for the two corporations may be utilized in applying the test for the first taxable year in which such control is acquired.\(^99\) Thus, acquisition of "control" in a taxable year may enable the issuing corporation to escape section 279 for such later year and thereafter. Conceivably, therefore, an issuing corporation could first lose the interest deduction under section 279, but later regain it upon acquisition of the requisite 80 percent amount of shares. One may well speculate about the premium which financial markets will place upon blocks of stock, the sale of which would enable the issuing corporation to become fully in "control" of the acquired entity.\(^100\)

g. Extrication from Permanent Application of Provision

While the statutory intent clearly requires that characterization of an instrument as corporate acquisition indebtedness will result in permanent disallowance of the interest deduction, certain rules permit change in such treatment if the circumstances of the taxpayer differ as time passes.

The general rule, of course, provides that once an obligation is deemed to constitute corporate acquisition indebtedness, it remains so characterized for all subsequent taxable years.\(^101\) Escape from this provision is available

\(^98\) See Rev. Proc. 66-34, 1966-2 Cum. Bull. 1232, 1233, which provides that the "substantially all" test for the purposes of "C" reorganizations is satisfied if 70 percent of the value of the gross assets and 90 percent of the value of the net assets is acquired.

\(^99\) The rule is not permissive.

\(^100\) While a similar situation obtains in connection with corporations seeking to consolidate (or to liquidate subsidiaries), the result in a case of acquisition debt may be more dramatic in light of the frequently hostile circumstances in which corporate "take-over" transactions arise.

\(^101\) I.R.C. § 279(d)(2).
if (a) "control" is acquired, as heretofore noted, and the combined earnings results enable the corporation to avoid application of the projected earnings test;\(^\text{102}\) (b) three consecutive taxable years pass, as of the close of each of which the issuing corporation's debt-equity ratio or projected earnings coverage change sufficiently to avoid the strictures of those provisions.\(^\text{103}\) In such event, the issuing corporation now having been "purged," may deduct interest for all future years. Nothing in the statute suggests that the disallowance rule could be reinstated where, in a subsequent year (having once met the three consecutive years test), the corporation's financial circumstances deteriorate so that it again fails to meet the debt-equity ratio or projected earnings requirements.

2. Rules Differentiating Between Debt and Equity—Section 385

To underscore the Congress's resolve that corporate earnings may not be distributed as interest payments, and doubtless to settle in a much more general context the question of whether corporate payments are interest or dividends, section 385 was added to the Code granting authority to the Treasury to identify factors which will establish the existence or nonexistence of a debtor-creditor relationship between a corporation and the holder of its securities.

Section 385(b) sets forth a recitation of the factors relevant to "a particular factual situation." These include: (1) the existence or nonexistence of a written unconditional promise to pay; (2) the existence or nonexistence of an obligation to pay on demand or on specified maturity date; (3) the requirement or lack of requirement to pay a sum certain in money; (4) the requirement (or lack of it) that the debt arise in return for "adequate" consideration in money or money's worth; (5) requirement of payment of a fixed rate of "interest"; (6) the existence of subordination or preference; (7) the ratio of debt to equity; (8) the existence or nonexistence of convertibility; (9) the relationship between holdings of stock and holdings of the instrument. While no reference appears with respect to an investment unit which includes a warrant or option to purchase common stock, there would appear ample authority for its consideration. Other factors heretofore noted by the courts, but not identified in the statute, include: (1) the existence or nonexistence of a sinking fund;\(^\text{104}\) (2) a requirement that payments be made in all events, whether or not current earnings are available;\(^\text{105}\) and (3) the provisions, in the event of default, for the acceleration of the balance of payments due.\(^\text{106}\)

While it is well beyond the scope of this paper to suggest specific rules

\(^{102}\) Id. § 279(d)(3).

\(^{103}\) Id. § 279(d)(4).

\(^{104}\) See, e.g., Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962).

\(^{105}\) See, e.g., Talbot Mills v. Commissioner, 3 T.C. 95, aff'd, 146 F.2d 809 (1st Cir 1944), aff'd, 326 U.S. 521 (1946).

which will be the product of considerable discussion in the Treasury, it
should be observed that the regulations authorized by section 385 will
apply to disallow the interest deduction although a corporate taxpayer may
avoid the provisions of section 279. While the latter provision applies with
respect to "interest," the former determination as to whether interest has
been paid will be made under section 385. Failure to meet the criteria
there established will prevent the taxpayer from entering the narrow pro-
visions of section 279.

3. Original Issue Discount—Section 1232

The amendments to section 1232 and the addition of specific reporting
requirements under section 6049 attempt to establish an integrated statutory
pattern for the treatment of original issue discount at both the issuing
corporation and holder levels.

The rules newly incorporated in section 1232 require that the amount
of the original issue discount (determined ratably on a monthly basis for the
life of the obligation) be includible in the gross income of the holder.
Rules are also provided which extend the statutory rationale to a purchaser
of the obligation. Such person continues to include in income the
unamortized balance or the original issue discount, but reduces the amount
so includible (on a ratable basis over the remaining life of the obligation)
by the excess of the price paid over the original issue price plus a portion
of the original issue discount already includible in income. To assist in
the administration of this provision and prevent loss of revenue at the
holder level, reporting requirements are incorporated in section 6049 requir-
ing the issuer to file information returns respecting the amount of the
discount with copy to the holder.

More difficult is the question of determining the amount of the original
issue discount. The statute establishes, and thus puts to rest the conceptual
issue under prior law, the extent to which original issue discount can, or
cannot, arise when debt is issued for property. Whereas the House version
of section 1232(b) would have provided that the fair market value of
property constitutes the issue price in all cases, the statute, by amendment
on the Senate floor, changed such rule to limit its application to situations

107 See I.R.C. § 279(j).
108 Tax Reform Act § 413.
110 I.R.C. § 1232(a)(3)(B). A "purchase" is defined as any acquisition of a bond if the
basis of the obligation is not determined by reference in whole or in part to the adjusted
basis of such obligation in the hands of the transferor under section 101(a), relating
to property acquired from a decedent. Id. § 1232(a)(3)(C).
111 Id. § 1232(a)(3)(B)(i), (ii).
112 Id. § 6049(a)(1), (c).
113 Id. § 1232(b)(2).
114 House Version § 413(b).
in which the debt in exchange for which the property was acquired was either part of a securities issue, a portion of which was traded "on an established securities market," or the acquired property was itself publicly traded stock or securities.\(^\text{116}\) Even in such instance, if the acquisition transaction itself was effected pursuant to a nontaxable reorganization under section 368(a)(1) or an insolvency reorganization, no original issue discount arises, nor does original issue discount, so the statute makes completely clear, arise in any other situation in which the debt is issued for property other than money. In these instances, the issue price is the stated redemption price at maturity.\(^\text{117}\)

Although the Senate floor amendment limiting the cases in which original issue discount can arise where debt is issued for property narrows the problem of determination of the amount of such discount, the public securities cases in which the question will arise still, it is suggested for reasons previously noted, present problems of valuation. Indeed, the Senate Finance Committee Report, while referring to the necessity for a determination, sets forth no guidelines for ascertainment of value.\(^\text{118}\) Also to be noted is the possibly anomalous consequence of a reorganization situation. If the extent of the debentures in relation to the stock is sufficiently large to preclude characterization, for purposes of section 368, of the acquisition as a statutory merger for purposes of section 368(a)(1)(A), original issue discount will arise. On the other hand, if the relationship of stock to the debentures satisfies continuity of interest tests and other provisions of section 368, no original issue discount will arise. The selling shareholders will be taxed on the debentures received in the exchange as "boot" (usually, but not necessarily always as a dividend) to the extent of their fair market value. Where such fair market value is less than the issue price, the selling shareholders can realize upon the discount as if the bond had been sold.

4. **Premium**

To add partly to correlation of the taxing pattern in debenture acquisitions, a new provision, section 249, restricts the amount which a repurchasing corporation may deduct when it acquires its debentures at a
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premium.\textsuperscript{119} By incorporating in the statute a rule, expressed, but not applied with total success, in the regulations,\textsuperscript{120} a corporation which repurchases its obligations at a price in excess of "a normal call premium" may not deduct such excess unless the corporation establishes to the Treasury's satisfaction that the amount of such excess is attributable to the cost of borrowing and not the conversion feature of the obligation.

It is to be observed that no reference is made in the 1969 legislation as to the treatment of the premium to the issuing corporation to the extent it arises upon issuance of the obligation. It is important to note that a provision respecting generation of income comparable to section 249 was not added to the Code. To achieve full consistency, language could have been developed to provide that the amount of income arising from bonds issued at a premium would be limited, in the case of convertible debt, to that portion of the premium attributable to money rates, with the excess amount made referable to the conversion feature (or the warrants if issued as part of an investment unit). In the absence of such language, reliance will continue to be had upon that part of the regulations\textsuperscript{121} which does not treat as income any portion of the excess of the issue price attributable to the conversion feature. Any value in excess of the face amount of the debenture and the amount determined to be referable to the warrant remains, as heretofore noted, subject to premium income characterization.

IV. Perspective

The dramatic dampening in the latter part of 1969 of the lush and verdant merger climate which had flourished as the decade approached maturity could not fairly be attributed to the acquisition debt provisions of the Tax Reform Act of 1969, stunning as was the speed with which their passage occurred once reported by the Ways and Means Committee. Other well known factors certainly contributed as much, and probably far more, to diminish somewhat the frenetic pace with which 1969 had begun: the Government's policy of monetary restraints which restricted funds available for cash acquisitions; erosion in stock market prices generally with specific emphasis upon the deterioration of earnings of conglomerates; and continued governmental concern respecting concentration of ownership of industrial resources. The sharp rise of interest charges to record heights seemed also to have caused the cost of these issues to become prohibitive in absolute terms, quite independently of tax deductions, and the lower yields available with respect to convertible securities (or those accompanied by warrants). Without question the overhang since late February of 1969 of H.R. 7489, having a then current effective date and expansive scope, also operated to make the typical debt-equity take-over "package" highly

\textsuperscript{119} Tax Reform Act § 414.
\textsuperscript{120} Treas. Reg. § 1.163-3(c) (1968).
\textsuperscript{121} Id. § 1.61-12(c)(2) (1968).
risky or unavailable. At no time, however, did H.R. 7489 purport to deal with the broader question of the tax treatment of mergers in a more general sense; indeed, by restricting the scope of the provision to the category reflected in section 279, Congress has successfully achieved a solution confined substantively to the purely tax-motivated transaction which gave rise to the legislation's initial introduction.

By the same token, H.R. 7489 and the issues it raised gave impetus to the Treasury's more general inquiry respecting the broader question of whether "mergers or other consolidations among corporations, particularly in the area of the so-called conglomerate combinations constitute[s] a threat to the competitive climate for U.S. business and to growth opportunities for new firms."122 In testimony before the Ways and Means Committee, presented on April 22, 1969, respecting H.R. 7489, Assistant Secretary Edwin S. Cohen, for the Treasury, stated as follows:

It is also appropriate to investigate the question whether the present tax laws offer special inducements [to mergers]. From the evidence presented to this committee and from the data [acquired by the Treasury, it is apparent] . . . that the basic tax provisions encouraging the merger movement is that which accords tax-free treatment to reorganizations. Over 90 percent of the mergers in recent years have employed some form of tax-free reorganization. [The Treasury is beginning an immediate study] . . . of the application of the reorganization provisions . . . to see if the rules developed some years ago are still appropriate to current conditions and practices. 123

In thus serving notice of the Treasury's intent to reexamine this field, Mr. Cohen very properly made clear that "the total Congressional concern should be reflected in a number of areas including possible extension of the antitrust laws, revision of security regulation and accounting rules and regulation of bank loans to the extent that present loan limitations facilitate new consolidations."124

While a comparison between the factors considered by the Congress respecting debt-financed acquisitions and the broader area of nontaxable reorganizations is not in all respects a perfect one, sufficient relationship exists to suggest that comparable trend lines may appear in legislation respecting the larger subject. Discussion of these factors follows.

1. Characteristics of Merging Companies and Business Purpose

Although the 1969 legislation was introduced in the context of hostile "take-overs" by "conglomerate" corporations, neither H.R. 7489 nor section 279 is framed in those terms. As enacted, section 279 encompasses not only conglomerate mergers of companies engaged in noncompeting product lines but also so-called congeneric (horizontal (competitive) and vertical (sup-

123 Id. pt. 14, at 5493.
124 Id.
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Acquisition) acquisitions. Nor do the friendly or unfriendly circumstances surrounding a merger transaction affect the statute's applicability. Moreover, even if the specific terms of section 279 are avoided, the overriding conditions of section 385, authorizing the Treasury to prescribe regulations setting forth factors to be taken into account in determining whether a debtor-creditor relationship exists, must be satisfied.

Once implemented, the regulations can be expected to articulate elements which will restrict the utilization of the interest deduction to those cases in which the payee's interest in the acquiring business is essentially nonproprietary in character.

A comparable methodology may be implemented to ascertain, as the first of several premises, whether the circumstances of a purportedly nontaxable acquisition justify—in terms of its economic merits—such characterization. For example, it would not appear that antitrust issues which relate to the conglomerate or congeneric classification of the merger are essentially matters of federal income tax concern. If these or other public policy issues are present (for example, securities law), appropriate effect can be afforded to each discipline so affected, limited, however, by its proper sphere of influence. To measure all of the foregoing—perhaps much more realistically than now occurs under existing law and administration—consideration can be given to enactment of a provision which would authorize the Treasury to articulate in more detail the so-called "business purpose" doctrine in a manner similar to that now authorized respecting characterization of the debt-equity relationship under section 385. This doctrine, although grounded in landmark decisions and ancient regulations, which require that a corporate amalgamation "be undertaken for reasons germane to the continuation of the business of a corporation a party to the reorganization," adds very little, in actual practice, to the generality of the statute. Expression in more specific terms of a "business purpose" doctrine which gives effect to the more subtle motivations involved in corporate combinations seems in order.

Among the points which could be considered are those, for example, which concern the degree to which the availability of tax attributes of the acquired company may have positively or artificially induced effectuation of the transaction. Net operating losses constitute an obvious example, and there are many others. The impact of related rules which apply in other disciplines (for example, the accounting presentation resulting from consummation of the reorganization) could also be appropriately considered in terms of the consequences of nontaxable or taxable characterization of the transaction.

125*Hearings, supra* note 129, at 552. The following comment is made under "Matter for Further Consideration": "The Advisory Group suggests that it may be found desirable on further consideration to provide for complete nonrecognition of gain at the corporate level, regardless of whether boot is received or whether, if received, it is distributed to shareholders or paid over to creditors."
Pertinent to the foregoing is a reexamination, suggested a decade ago by the Advisory Group on Subchapter C,\textsuperscript{126} of the half-century old assumption that the term "reorganization" as the touchstone of nontaxability must necessarily apply uniformly at both the corporate and shareholder levels. Policy considerations may well dictate that while reorganization treatment is appropriate with respect to the acquiring corporation, a different rule should obtain respecting the selling shareholders, or the converse may be true. The dependency of present law upon a single definition substantially prevents this result. It also precludes, with respect to the acquiring entity, partial reorganization treatment, even though shareholders may incur, by reason of sales to third persons, some tax.

Much more difficult than mere recitation of the desirability of more flexibility is the development of workable rules which would articulate circumstances under which reorganization treatment would be granted (or required) at the corporate level. All that is intended to be stated here is that the determination of whether a "purchase" or "reorganization" has been effected with respect to an acquiring entity should involve factors pertinent to that corporation's affairs, perhaps focusing on the nature of the consideration surrendered by the acquiring entity, rather than, to the degree now required under current administration, upon actions of the transferors who sell their shares to third persons.\textsuperscript{127}

2. Shareholder Level Aspects

By eliminating the availability of installment treatment for "readily tradable" evidences of debt, the 1969 legislation has enunciated (or clarified, as only time and possibly litigation may tell) a policy which treats as the equivalent of cash (to the extent of fair market value) debt securities received as the consideration for the sale of a business.\textsuperscript{128} It is significant that the strain upon the installment method provisions must clearly become evident in connection with convertible debentures or investment units accompanied by warrants, securities which in the financial market place often possess an equity or proprietary cost.

The foregoing discussion suggests that whereas in the case of the 1969 legislation the central issue may have been corporate level concern (for the interest deduction as an inducement factor), the Treasury's reexamination of the nontaxable acquisition provisions may be heavily focused on the shareholder level effects. These inquiries may proceed from at least two aspects: (1) in the reorganization and sale definitions, the question may turn on the manner in which the sellers' continuity or interest in the acquiring corporation is maintained; (2) in terms of concepts of taxation of wealth accretion and income realization, reconsideration may be given to those

\textsuperscript{126} Then being considered as part of the pending tax revision proposals.

\textsuperscript{127} See Treas. Reg. § 1.368-2(g) (1955).

\textsuperscript{128} Where bonds are received as "boot," the Internal Revenue Service has consistently taken the position that installment treatment is not available.
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events which economically generate gain and respecting which — giving due regard to the financial and administrative factors involved — recognition (present or deferred with assured tax) is appropriate.

Continuity of interest can be considered in terms of (a) the nature of the proprietary or nonproprietary relationship which the seller holds respecting the acquiring entity after the transaction, and (b) the degree or remoteness of such relationship, measured by size of the business or the percentage of resulting ownership.

Where the seller receives preferred, whether convertible or not, and regardless of whether a right to vote attaches, its economic significance to the holder is measured by the par amount of the instruments plus, depending upon terms, dividend responsibilities. That a selling shareholder may receive these instruments, but not convertible subordinated debt, without tax justifies, it would seem, reexamination of the propriety of the distinction. While it is true that a preferred shareholder is not a creditor, the existence of voting rights (often extremely limited) does not obscure the fact that his stake in the acquired enterprise may differ only as a matter of priority in liquidation from that of the debenture holder. Even more questionable is the drastic difference, to which reference has previously been made, in the tax treatment to the issuing corporation.

At the other end of the spectrum may be placed nonvoting common, where the shareholder has no power or control over the enterprise's business, but whose financial stake in it is entirely dependent upon its success or failure only after the rights of prior security holders have been accounted for. Framed in these terms of proprietary risk, a shareholder who exchanges securities for common stock may have altered the character of his investment (depending upon the business nature of the acquiring entity and its size in relation to the company whose shares were surrendered) and (depending upon voting percentage) may have changed the degree of his control over the enterprise. He maintains, nevertheless, a continuity of the order (in relation to prior securities) of his risk relationship to it. So viewed, the question of the differing size and nature of the acquired and the acquiring entity may not be regarded as material to continuity of interest as the re-

129 A different consideration would obtain if the preferred were convertible. While the conversion right, if exercised, can place the preferred shareholder in the same position as the common, such person, prior to exercise, has the protection of an economic floor in terms of his risk relationship to the business. For this reason, the character of his investment should, it is believed, be viewed in terms of its primary issuance (preferred) character. There are, of course, limitless varieties of preferred shares, including those with fixed call dates, those which are cumulative and noncumulative in character and those which possess other characteristics which would cause them to be classified as other than common stock (e.g., such as with respect to section 306). To avoid endless definitional problems, any rule designed to exclude preferred stock from nontaxable receipt in a reorganization would probably be phrased in terms comparable to those used for section 306 as stock "other than common stock" (section 306(e)(1)(A)).

130 The preferred may be nonvoting in a statutory merger and may possess limited voting rights in a "B" or "C" reorganization. It may be convertible in all cases.
tention of the risk relationship. While it cannot be doubted that the acquisition of a small single product line company by a large publicly traded and diversified conglomerate enterprise may provide the transferor with an investment instrument of essentially different quality, the value of that certificate continues to be measured to some degree in terms of the fortunes of the acquired enterprise.\textsuperscript{131}

A reexamination of the propriety of this result could produce a policy response ranging from total recognition (including treatment of gain as a tax preference) to continuation of present law or even an extension thereof (permitting a nontaxable "roll-over" of comparable securities).

Also pertinent to review of the continuity of interest doctrine as a measure of continued nontaxability is the treatment of cash or other "boot" which may be received by the seller from the acquiring entity or realized by him through the sale of some of his shares. Present administrative practice authorizes a transactional characterization as a reorganization, where the acquisition, if effected as a statutory merger, includes boot emanating from the acquiring corporation. To produce this result, at least 50 percent of the total consideration must consist of stock of the acquiring company.\textsuperscript{132} Such rule obtains even though an individual shareholder, such as one dissenting from the transaction, may be paid entirely in money. Where the transaction is effected as a stock-for-stock reorganization under section 368 (a)(1)(B) or stock-for-assets reorganization under section 368(a)(1)(C) (in which, except in special circumstances, no boot may be received), the seller may often convert a portion of the consideration received into cash or similar property through the sale of the shares to third persons as part of or immediately after the transaction's consummation. Here again, administrative practice limits the number of aggregate shares which may be disposed of to 50 percent of the aggregate consideration offered.\textsuperscript{133}

While these provisions give the acquiring corporation considerable flexibility in satisfying the differing needs of various shareholders, it can here be contended that less capricious rules are needed. A "B" or "C" reorganization should not be destroyed (with the attendant stepped-up basis which results to the transferee corporation) with respect to all the shareholders because of a de minimis issuance of boot. Conversely, it is questionable whether the transferor shareholders should be able to dispose of substantial shares for money to third persons while reorganization consequences remain at both corporate and shareholder levels.

Apart from continuity of interest considerations, an underlying issue persists as to whether the effectuation of a corporate acquisition for securities, in a case in which gain is realized, represents an appropriate point at which to exact a tax. Put another way, in terms of the theme propounded by Assistant Secretary Cohen and Chairman Mills, does the absence of such

\textsuperscript{131} Giving effect, of course, to market conditions generally.


\textsuperscript{133} Id.
exaction so distort the nontax economics of the transaction so as to produce affirmatively an event which would, or would not have occurred, principally depending upon tax effects.

In the half century which has passed since statutory reference was first made to reorganization exchanges, justification for nonrecognition treatment has been offered on the grounds that the exchanges were "purely paper" in nature; "merely changes in form and not in substance"; or involving a "mere rearrangement" of the corporate structure. In today's economy, it is difficult to apply such a characterization to the complex combination of events which constitute a corporate combination.

Perhaps the issue having most current relevance in the light of today's economic climate and the concern, generally, with mergers, relates to the marketability or liquidity of the securities received by the shareholder. If, as often occurs, a closely held enterprise is acquired by one whose shares are publicly traded, the selling shareholder may well have converted a non-liquid investment into one which is "readily tradable" in the market place and which is (at least in part) giving effect to blockage and similar considerations, or may be the equivalent of cash. Without question, the opportunity to enter into transactions of this nature (particularly when coupled with the economic diversification and assumed liquidity for estate tax purposes) has certainly occasioned reorganization exchanges. It has been vigorously argued\textsuperscript{34} that transactions in which the stock received is publicly traded and "hence in substance the equivalent of cash" justifies, or even requires, the imposition of tax. Assuming the validity of the rationale of the rule, its implication raises numerous technical difficulties. A large block of stock constitutes the equivalent of cash only to the extent that it has in fact been sold and a determinable amount realized. Investment letters which now accompany reorganization exchanges in many cases require the holding of the shares for an indeterminate period of time at the conclusion of which the value may differ considerably from that which obtained at the time of the exchange.

The development of provisions which would delineate circumstances in which shares would, or would not, be regarded as readily tradable (such as the shares traded on selected national exchanges) could divert reorganization transactions to companies not so listed. Valuation by reference to quoted market prices will not necessarily represent a measurement of true value. A rule which taxes only the shareholders of the acquired corporation will inject an artificial note into the bargaining between corporations of relatively equal size. Further, in any situation in which the acquisition (because of the nature of the acquired business) effects a substantial change in the character of the acquiring entity, a rule taxing only the surrendering shareholders would seem to enable, perhaps inappropriately, the shareholders of the acquiring entity to avoid an equivalent imposition of tax.

\textsuperscript{34} See Hellerstein, Mergers, Taxes, and Realism, 71 Harv. L. Rev. 254 (1957).
If, notwithstanding, a rule were to be considered in terms which withdrew in whole or in part nonrecognition treatment in any of these situations, such rule should be limited to those cases where the surrendering shareholder can effectively, i.e., actually through consummated sales of securities or distributions as part of the transaction, realize funds with which to pay the tax.

V. CONCLUSION

The 1969 legislation has effectively and, in general, fairly circumscribed tax inducements to debt-financed acquisitions. In thus legislating with respect to one segment of corporate combinations, reexamination has been summarized with respect to the larger question of the taxation of other nontaxable reorganizations. As the differential between ordinary income and capital gains has narrowed, the gap between nonrecognition treatment and capital gains has correspondingly increased. The strain upon the reorganization definition has therefore become increasingly great.

If legislative inquiry is undertaken, it is hoped that this will occur in a balanced framework which will take into account not only tax and nontax disciplines, but also the business essentiality of continuing consummation of normal corporate rearrangements.