Miching Mallecho: The Tax Reformers' Sneak Attack on Conglomerates

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The furore over conglomerates, and the many-pronged attack now being waged against them, have been characterized as the establishment’s response to such acts of lèse-majesté as Leasco’s bid for the Chemical. According to this rationale, the forces of securities regulation, antitrust and tax—to say nothing of the whole American Institute of Certified Public Accountants—have been mobilized to make the world safe from Sol Steinberg and Charles Bluhdorn. A bas les parvenus!

The explanation derives from the conspiracy theory of history. As is true of all others of like parentage, it can be tested only by reference to its outward manifestations. And if we make this test in the tax field, we are forced to conclude that either the establishment is pretty weak, or that its sense of outrage with the conglomerateurs¹ is pretty mild. For here, at least, the response is remarkably faint-hearted.

In its report accompanying the Tax Reform Bill of 1969, the Ways and Means Committee never expressly condemned the merger movement as evil; the implication was there, but not the flat statement. Noting that “in recent years, there has been a significant increase in the number of corporate mergers . . . and also in the size of the corporations involved,”² the report observed that “[t]his trend . . . raises numerous significant questions, such as its effect on the competitive climate . . . , including the growth opportunities available for new firms, the changes . . . in the degree of economic concentration . . . , and the overall effect . . . on the . . . economy.”³ This, said the Committee, impelled concern for those “features of the tax laws . . . [believed to] provide a special and unwarranted inducement to mergers.”⁴ For such features, four remedies were deemed salutary:

First, disallowance of a part of the interest deductions otherwise allowable to a corporation in any year in respect of the debt it has incurred in making acquisitions;⁵

Second, denial of the use of the installment method for reporting gain in transactions not requiring periodic payments, or in those in which the purchaser’s obligation takes the form of a marketable security;⁶

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¹ I am not sure that this is a legal or commercial word of art. I have seen it used only in the society columns of a newspaper: “The Marquesa de Portago,” the report read, “was married here yesterday afternoon to Richard C. Pistell, the conglomerateur.” N.Y. Times, May 23, 1969, at 41, col. 1 (city ed.).


³ Id.

⁴ Id.


⁶ Id. § 412, I.R.C. § 453(b) (amend.).
Third, requiring the holders of corporate debt to accrue any original issue discount thereon over the life of the obligation instead of accounting for such discount upon sale or maturity;\(^7\) and

Fourth, limiting the deduction allowable to a corporation upon a repurchase of its own convertible debt at a premium to an amount equal to "a normal call premium on . . . evidences of indebtedness which are not convertible."\(^8\)

To even the most casual observer, these remedial provisions do not seem to remedy very much. The conglomerate ("conglomerate" according to more than one unconscious wit) movement may, indeed, suffer far more as a result of other provisions of the Tax Reform Act not specifically aimed at it. Thus, new rules that will subject to tax stock dividends paid on preferred stock, or distributions or arrangements (including those involving both convertible preferred and convertible debt) which have the effect of shifting proportionate interests within the corporation,\(^9\) could have the effect of curtailing use of the kinds of securities issued in conglomerate acquisitions. Since one has the impression that many conglomerate mergers have succeeded simply by reason of the imaginative paper used in them, such a limitation might prove fatal to future transactions so based.

In its recent report on mergers, the staff of the Federal Trade Commission (FTC) singled out, as one of the "institutional biases encouraging mergers," the favorable tax treatment accorded ABC transactions in the extractive industries.\(^10\) Two acquisitions — those of Consolidation Coal by Continental Oil in 1966, and of Peabody Coal by Kennecott Copper in 1968 — had certainly involved use of the device; a third, the acquisition (also in 1968) of Island Creek Coal by Occidental Petroleum may have.\(^11\) The new law treats all production payments, both carved-out and retained, as loans by their holders to the owner of the mineral property.\(^12\) This particular aid to economic concentration has now passed on into history.

The Senate Version of the Tax Reform Bill struck at least one blow at mergers that the House Version had missed. It appeared that a number of corporations, primarily insurance companies, had accumulated sizable blocks of their own shares in exchanges for appreciated securities. To the sellers of the shares the tax result was the same as would have obtained in cash transactions. For the corporations, however, there was an enormous difference: the exchanges, according to Internal Revenue Service rulings, resulted in no recognized gain, and

\(^{7}\) Id. § 413, I.R.C. §§ 1232(a), 1232(b)(2), 6049(c) (amend.).

\(^{8}\) Id. § 414, I.R.C. § 249 (new).

\(^{9}\) Id. § 421, I.R.C. § 305 (amend.).


\(^{11}\) Id.

the . . . companies can then retire the stock they have bought back, thereby increasing pershare earnings. Or they can use it later to make acquisitions—again on a tax-free basis. (Because of the convolutions of the tax laws, the companies cannot use portfolio stock directly in an acquisition without paying the usual capital gains tax.)

It is evidence of present Congressional sensitivity to tax abuse that the story from which the above is quoted had not even reached the public before the Senate Finance Committee announced action. "This sort of exchange in the future," the press release said, "will give rise to taxable gain."

In any event, section 905 of the Act amends Code section 311 to provide in general that when (after November 30, 1969) a corporation distributes property (other than its own evidences of indebtedness) in redemption of its stock, and the property has a value in excess of the corporation's basis therefor, then gain will be recognized just as if the corporation had then sold the property so distributed. The new rule will not apply to distributions in complete or partial liquidation, or to those made in connection with reorganizations or split-offs. It will also be inapplicable to:

1. distributions completely terminating the interest of a 10 percent (or more) shareholder;
2. distributions of the stock of 50 percent (or more)-owned subsidiaries;
3. distributions in compliance with antitrust decrees;
4. distributions to effect section 303 redemptions;
5. distributions to private foundations to reduce their "excess business holdings";
6. distributions by regulated investment companies.

The exceptions serve only to make the jest more excruciating. One must pity the poor tax planner. He no sooner gets a good thing going than some nudnick stridently blows the gaff.

Typically, the coin used in an acquisition is stock of the acquiring company. For this reason, the market popularity of that stock is determinative of the company's capacity for engaging in the operation. Anything that lessens the public's appetite for the glamor issues is a deterrent. The disallowance of some of the interest deductions of non-corporate taxpayers on

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13 The Great Tax-Free Cash-In, FORBES, Nov. 1, 1969, at 52 (emphasis as in original).
14 Cf., Watts, Recognition of Gain or Loss to a Corporation on A Distribution of Property in Exchange for its Own Stock, 22 TAX LAW. 161 (1968).
16 Id. See also H.R. REP. 782, at 333.
18 Id. § 311(d)(1)(B).
19 Id. § 311(d)(1)(C).
20 Id. § 311(d)(1)(D).
21 Id. § 311(d)(1)(E).
22 Id. § 311(d)(1)(F).
23 Id. § 311(d)(1)(G).
24 The staff of the FTC estimates that 85 percent of "recent large mergers" were tax-free stock-for-stock transactions. FTC REPORT 25.
account of debt incurred to make investments might have such an effect: the acceptance of an exceptionally low current yield, the identifying feature of growth stocks, would necessarily extend this disallowance. Inhibitions on the investments of private foundations and other exempt organizations might also weaken the market, as also might the repeal of the investment credit and restrictions on the use of accelerated depreciation methods.

Both of these last will probably prove of less significance today than they would have before the AICPA and the SEC began to focus on some of the more misleading accounting practices. Nevertheless, to the extent that stock prices have depended on cash flow rather than earnings, the new restrictions will act as depressants.

DEBT-FINANCED CORPORATE ACQUISITIONS AND RELATED PROBLEMS

The ineffectiveness of the Act’s four anti-conglomerate sections lies in their limited scope. The deductions disallowed by new Code section 279, for example, will be only some part of the interest charges for “corporate acquisition indebtedness.” This is not all of the debt incurred in making acquisitions — far from it. The debt involved must have these characteristics:

1. it must be issued after October 9, 1969;
2. its purpose must be to provide consideration for the taxable acquisition of stock in, or at least two-thirds (in value) of the operating assets of another corporation;
3. it must be "subordinated to the claims of trade creditors of the issuing corporation generally," or "expressly . . . to . . . any substantial amount of [such corporation’s] unsecured indebtedness"; and
4. it must be either convertible into stock of its issuer, or part of an investment unit that includes an option to acquire such stock.

Moreover, debt conforming to these requirements can become “corporate acquisition indebtedness” only if at the end of any year while it is outstanding its issuer either has a debt-equity ratio (as defined) in excess of 2:1, or “projected earnings” no greater than three times its annual interest requirement. And once corporate acquisition indebtedness has been iden-

24 H.R. 13270, at § 221. On the Treasury’s recommendation, the Senate Finance Committee proposed the elimination of this provision of the House Bill “pending further study.” S. REP. 552, at 305-06. The Conference Committee restored it in somewhat modified form, effective beginning in 1972. H.R. REP. 782, at 299-300. For years prior to 1972, the excess investment interest of non-corporate taxpayers will constitute an item of tax preference subject to the 10 percent minimum tax. I.R.C. § 57.
25 Tax Reform Act §§ 101, 121.
26 I.R.C. § 703.
27 I.R.C. § 521. See also §§ 301, 442.
29 Tax Reform Act § 411, I.R.C. § 279(b).
tified, deductions for the interest on it will be disallowed only to the extent that in any year they exceed the difference between $5 million and the interest paid by the taxpayer on debt incurred after December 31, 1967, in making acquisitions that is not corporate acquisition indebtedness.\textsuperscript{30}

This brief, elliptical, and probably confusing summary by no means comprehends all of the complexities and ambiguities of the section. It does, however, suggest why the Section of Taxation of the American Bar Association thought it likely to “contribute little toward [the] accomplishment of its major purpose.”\textsuperscript{31} A lot of debt has to accumulate in order to create an annual interest obligation of $5 million. And, while much of the debt issued nowadays is convertible, rather less may be sufficiently subordinated to qualify. Even the convertible problem could in many cases be avoided through the simple expedient of causing a subsidiary to issue debt accompanied by warrants to acquire stock of the parent or of some other corporation.

A further softening of the impact of the interest proposal arises from a curious diffusion of the congressional purpose. Quite gratuitously, or so it would seem, the Ways and Means Committee's report on the provision, in addition to its strictures on tax-induced mergers, embarked upon a discussion of the difficulties in distinguishing, for tax purposes, between debt and equity. There followed the bland assertion that the conglomerate trend made it appropriate at this time to take action to resolve in a limited context the ambiguities and uncertainties which have long existed in our tax law.

The level of merger activity and its economic implications have made this problem of much greater significance than was previously the case.\textsuperscript{32}

The resolution brought to the law's ambiguities and uncertainties by the House Bill was not self-evident. It provided that “[n]o inference shall be drawn from any provision in this section [279] that any instrument designated as a bond, debenture, note or certificate or other evidence of indebtedness by its issuer represents an obligation or indebtedness of such issuer in applying any other provision of this title.”\textsuperscript{33} Further, although the criteria for corporate acquisition indebtedness resembled those applied in thin capitalization cases, it departed significantly from the latter. Those cases had

\begin{itemize}
\item \textsuperscript{30} Id., I.R.C. § 279(a).
\item \textsuperscript{31} Hearings on H.R. 13270 Before The Senate Comm. On Finance, 91st Cong., 1st Sess. 5189 (1969) [hereinafter cited as Senate Hearings]. The provision was opposed on similar grounds by the Committee on Taxation of the Association of the Bar of the City of New York, which also thought it a possible trap in respect of all interest deductions, too complex, and “essentially a regulatory and not a revenue raising provision.” Id. at 1616-17. The American Institute of Certified Public Accountants argued that “any restrictions on the 'tide of conglomerate mergers' should be imposed outside the tax law.” Id. at 4776.
\item \textsuperscript{32} H.R. REP. 413, pt. 1, at 104.
\item \textsuperscript{33} House Version § 411(a), I.R.C. § 279(1).
\end{itemize}
determined debt-equity ratios on the basis of going concern value; it
the Bill made this determination by reference to the tax basis of the issuer's
assets. Assuming, however, that the disallowance of some interest resolved
a major part of the problem, still other parts of importance were not even
touched: if no deduction were allowed for interest, did this make it a div-
idend? What would happen if the debt involved were retired or became
worthless? Could such debt, with or without some kind of voting right, qual-
ify for tax-free use in a reorganization or section 1036 exchange? Would it
constitute a second class of stock so as to make a Subchapter S election un-
available? The intrusion of these extraneous issues could not fail to weaken
the anti-conglomerate thrust; it may have been in recognition of this fact
that the Finance Committee appended the provision, hereinafter discussed,
for new regulations on the subject of debt versus equity.

The Senate accepted the House approach to the deductibility of in-
terest on acquisition debt. Its changes in the provision, most of which were
enacted, were not great, but their general tenor was lenitive. For example,
the House Bill had allowed no more than a very narrow escape from the
characterization of debt as corporate acquisition indebtedness. The Fi-
nance Committee substantially widened this: the disallowance of interest
deductions will be discontinued whenever an issuing corporation has run
for three successive years with both debt-equity and income-interest ratios
within the limits required in the first instance (as alternatives) to avoid
corporate acquisition indebtedness status.

The changes in the installment reporting rules may be more far-reach-
ing. It is probably true, as the Ways and Means Committee found, that
when an acquisition is made

by exchanging debentures of the acquiring corporation for . . . stock
[of the acquiree] . . . . [m]uch the same tax-free effect [as arises upon a
reorganization exchange of stock for such stock] . . . . is achieved by the
former shareholder if he elects to report the gain on the installment
method. Moreover, if the debentures are not redeemable for a long period
of time . . . . , no gain with respect to the debentures needs to be reported
until the end of that period, that is, his tax is deferred until that time
if he holds the debentures to maturity.

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34 E.g., Miller's Estate v. Comm'r, 239 F.2d 729 (9th Cir. 1956), rev'g 24 T.C. 923
(1955).
35 House Version § 411(a), I.R.C. § 279(c)(2).
36 Id. § 411(a), I.R.C. § 279(d)(3). Under the House Version, once the taint of cor-
porate acquisition indebtedness had attached to an obligation, such obligation would have
remained tainted forever unless at a subsequent date the issuer were to have acquired
control, or substantially all the properties, of another corporation, and the combined
accounts of the issuer and acquiree at the end of the year of acquisition then satisfied
either the debt-equity ratio or the interest coverage test. H.R. REP. 413, pt. 1, at 196. The
Act in its final form retains this exception. I.R.C. § 279(d)(5). But see H.R. Rep. 413, pt. 2,
at 80, stating that only subsequent ability to meet the interest coverage test can cleanse
the obligation.
37 Senate Version § 411(a), I.R.C. § 279(d)(4).
It is also likely that the possibility of using the installment method has been one of the inducements offered to shareholders in some of the conglomerate acquisitions.\textsuperscript{39} That the method may in fact not be available where only one deferred payment is contemplated\textsuperscript{40} or where the debentures happen to be convertible (as is often the case),\textsuperscript{41} and that the tax consequences of installment reporting may not be as simple as the Committee suggested,\textsuperscript{42} are doubtless, in this context, irrelevant. If people believe they can have their cake and eat it too, the falsity of the proposition does not stop them. It is the belief that informs their actions and, in this instance, gives impetus to the merger movement.

The House response was double-barreled. In its original form, the Bill would, first, have permitted the installment election only for those sales of realty and casual sales of personality "in which the payments of principal or principal and interest are required to be paid periodically and in such amounts over the installment period as prescribed under regulations."\textsuperscript{43} To satisfy the "amounts" requirement, the Bill declared that it would be sufficient if:

\begin{enumerate}
\item[(A)] such payments are required to be made at least once every two years in relatively even or declining amounts over the installment period; or
\item[(B)] at least 5 percent of the principal is required to have been paid by the end of the first quarter of the installment period, at least 15 percent of the principal is required to have been paid by the end of the second quarter of the installment period, and at least 40 percent of the principal is required to have been paid by the end of the third quarter of the installment period.\textsuperscript{44}
\end{enumerate}

The second proposal was a new rule for determining whether a sale of realty or casual sale of personality could qualify as an installment sale. Code section 453(b)(2)(A) had provided that such qualification could occur only if, in the taxable year of the transaction, there were no payments at all, or if the payments that were made ("exclusive of evidences of indebtedness of the purchaser") did not come to more than 30 percent of the selling price. The House change would exclude from the term "evidences of indebtedness of the purchaser"

\begin{quote}
...a bond or other evidence of indebtedness issued by a corporation or a government or political subdivision thereof with interest coupons attached, in registered form, or in any other form designed to render such bond
\end{quote}

\textsuperscript{40} Appert, supra note 39, at 139-46.
\textsuperscript{41} Id. at 147.
\textsuperscript{42} Id. at 150-60.
\textsuperscript{43} House Version § 412, I.R.C. § 453(b).
\textsuperscript{44} Id. § 412(b) proposing addition of new paragraph (3) to I.R.C. § 453(b).
or other evidence of indebtedness readily tradable on an established securities market.\textsuperscript{45}

This latter provision represented acceptance in substance of one of the Nixon Administration's tax reform proposals of April 22nd.\textsuperscript{46} The Senate Finance Committee also accepted it, adding a proviso that registered bonds would not be deemed readily tradable if the taxpayer could establish that they were not.\textsuperscript{47} A Treasury recommendation with respect to the Bill that notes payable on demand should not constitute purchasers' indebtedness was likewise adopted.\textsuperscript{48}

On the other hand, the Treasury had recommended, and the Senate Finance Committee agreed, that the periodic payment provision should be deleted. The ground for the Treasury view was that this proposal was

a significant departure from existing law and could disrupt the pattern of legitimate commercial transactions where payment is deferred because of lack of ability to make immediate payment. This is precisely the situation that the installment sales provisions were designed to ameliorate.\textsuperscript{49}

Perhaps it was easier for the Treasury to take this position because the one-payment installment sale question had finally been resolved — at the administrative level. In Revenue Ruling 69-462,\textsuperscript{50} the Internal Revenue Service (IRS) held that the installment method is not available for reporting a gain on a sale of real property where no payment is received in the year of sale and the entire purchase price falls due 10 years later. Moreover, the ruling assumed that the same result had always obtained with respect to casual sales of personalty by reason of a regulations' requirement that in terms is confined in its application to dealers.\textsuperscript{51}

No less than the acquisition indebtedness solution, the installment sales provision seems only part of an assault-by-nibbling. To the extent that conglomeration has depended on the issuance of debt securities with some form of tax shelter for the recipients of those securities, the amendments to Code section 453 will make the exercise more difficult. They will not make it impossible. The particular drafting technique adopted with respect to readily tradable debt, for example, simply invites avoidance: the Act does not make the delivery of the evidences of indebtedness until the year following the year of sale would save installment treatment of the transaction.
The amendments also pave the way to controversy—who knows what is meant by "readily tradable on an established securities market"?

The FTC Staff Report On Mergers, submitted on November 4, 1969, endorsed the Tax Reform Bill proposals with respect to deductions for interest on acquisition debt and the use of the installment method for reporting gain when marketable securities are received. The Report observed, however, "that only about 15 percent of recent large mergers would classify as purchase transactions subject to legislative modifications now under review." The Report notes as well the Bill's failure to deal with the special way in which present law may foster acquisitions by companies dealing in consumer credit. The ability of Montgomery Ward to defer large amounts of tax on its receivables until they were collected has been cited as the key to the otherwise unlikely transaction that made Container Corporation a Ward (renamed "Marcor") subsidiary in November, 1968. According to officials of the new organization, Ward's earnings were not sufficient to utilize our full tax deferral. With this combination, we'll be in a position to bring the Container earnings under this tax-deferred umbrella . . . .

[T]he basic advantage to Container Corp., from the stockholders' standpoint, is that it enables us to extend our activity. There was some question in our mind . . . as to whether we would be able to finance our expansion just to keep our market position, not necessarily to expand it.

The magazine that carried this story was altogether justified in heading it, "The marriage . . . wasn't made in heaven, or even in Chicago, but in Washington." Washington's matchmaking consisted of the long-standing rule that a dealer in personal property may report its income from sales on the installment plan when the installment payments are received. One may question, nevertheless, whether the FTC staff was quite as justified in implying that Marcor was only one of many assemblies spawned by this particular tax accounting method, which was first officially allowed by regulation in 1919, though not supported by statute until 1926. If tax deferral had been productive of large numbers of mergers, it is difficult to believe the staff would have failed to mention them in its report.

Under the Act, the recovery of original issue discount on corporate debt remains ordinary income. In the case, however, of all obligations issued after May 27, 1969, the holders will be required to include in gross income

52 FTC REPORT 25.
53 Id.
54 Id. at 156.
55 The Tax Laws, Bless 'Em, FORBES, Dec. 1, 1968, at 27.
56 Id.
58 Revenue Act of 1926 Ch. 27, § 212(d), 44 Stat. 23 (1926). The codification was said to be necessary because three cases had held the regulations invalid. S. REP. No. 52, 69th Cong., 1st Sess. (1926), 1939-1 CUM. BULL. pt. 2, at 346-47.
for each year throughout the life of the bonds that year's ratable portion of
the discount rather than wait until the bonds are called for redemption or
sold.\(^5\) Moreover, such inclusion will be necessary both for those who first
acquire the bonds and for persons who purchase them at later dates, pro-
vided that the purchases are not made at premiums.\(^6\) In this respect,
Congress appears to have agreed that market discount represents a mere
adjustment of interest rate that should be taxed as such.\(^6\) To support en-
forcement of this new rule, corporations issuing their bonds or debentures
in registered form will be required to file information returns in respect of
the amounts of original issue discount accrued to bondholders in each
year.\(^6\)

The Act also added five sentences to the existing definition of "issue
price" in Code section 1232(b)(2). These establish statutory rules to cover
bonds included in investment units with options, and those issued in ex-
change for property. In the latter case, if the new bonds are traded on an
established securities market or are issued in exchange for stock or secur-
ities so traded, issue price will be determined by reference to the fair market
value of the property. But if this trading test is not met, issue price will
be deemed to be the stated redemption price at maturity.\(^6\) This provision
was designed "to clarify the situations in which original issue discount
might arise."\(^6\) The authorities had been in conflict on whether this could
occur in the case of debt issued for property, and at least one writer had
argued most persuasively that the enactment of Code section 483 in 1964
had effectively foreclosed the possibility.\(^6\)

That tax jockeying was possible under the old issue discount rules can-

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\(^5\) Tax Reform Act § 413(a), I.R.C. § 1232(a)(3).
\(^6\) Id. § 413, I.R.C. § 1232(a)(3)(D).
\(^6\) See de Kosmian, Original Issue Discount, 22 Tax Law. 339 (1969). The AICPA,
through its Tax Division, opposed § 413 of the House Bill, arguing that to require the
accrual of original issue discount would "violate the well-established rules of the cash
method of accounting and . . . add to complexity and information reporting difficulties
far out of proportion to the problem." Senate Hearings 4777. As an alternative solution,
the Institute suggested the exclusion from the definition of capital assets in I.R.C. § 1221
of all nonconvertible corporate debt, thus making all gains and losses on the disposition
of such debt ordinary income or deductions. Such debt, it was argued, "is acquired . . . for
the principal purpose of realizing a yield . . . . It appears that the market value . . .
fluctuates in large measure with reference to prevailing interest yields. Accordingly, it
seems reasonable to tax as ordinary income or allow as ordinary deductions gains or losses
on disposition of obligations which are primarily mere adjustments of yields." Id. It is
believed that the Tax Division of the Department of Justice has, in settlement negotia-
tions, occasionally taken the position that a gain on the sale or redemption of noncon-
vertible bonds constituted ordinary income unless the taxpayer could demonstrate that
such gain derived from a change in the credit rating of the issuer.

\(^6\) Tax Reform Act § 413, I.R.C. § 6049(a)(1). Neither of the tax committees seems to
have been disturbed by the fact that, once the obligation has passed from its original
holder to a purchaser, the amount reported will seldom equal the amount includible in
the holder's income. Cf. Senate Hearings 5193.

\(^6\) I.R.C. § 1232(b)(2), as amended, Tax Reform Act § 413(b).
not be denied. And it had been regrettable that the tax law, while allowing deductions to issuers for the discount on their bonds, was not requiring concurrent income recognition by the holders of those securities. Such inconsistencies of treatment inevitably give rise to avoidance transactions. But one may be permitted to doubt whether this was a significant incentive to the merger movement, or whether correcting it will to any degree reduce the number of conglomerate acquisitions. The connection between this tax incident and the process of corporate growth has simply not been proven.

The final expressly anti-conglomerate provision of the new Act is one requiring the issuer of a convertible bond (or any corporation in control of the issuer) who (after April 22, 1969) repurchases the bond at a premium to reduce its deduction on account of such premium to the portion thereof representing "a normal call premium on bonds or other evidences of indebtedness which are not convertible."6 A purported exception makes the rule inapplicable "to the extent that the corporation can demonstrate to the satisfaction of the Secretary or his delegate that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature."67 This means, of course, that, pro tanto, there is no excess, the amount in question having, under the circumstances, been absorbed into the normal call premium.

The Ways and Means Committee offered the provision as a clarifying amendment.68 For the future, it resolves a litigated issue in favor of the Service. The Service's view has been that when convertible securities were repurchased, the part of the price paid for them attributable to the conversion feature is analogous to a stock purchase for which, of course, no deduction is allowed. Seeing the Government argument as, essentially, that the result of the transaction should be determined as if the conversion had occurred and the stock itself had been purchased, the Seventh Circuit in Roberts & Porter, Inc. v. Commissioner rejected it:69

These notes were not, in fact, converted into stock and the stock then sold. There is no provision in the Code or the Regulations which requires allocation of a part of the total purchase price to the value of the conversion privilege. . . . If this situation represents a breach in our revenue wall, its repair must be effected by legislative action rather than by judicial interpretation.70

The invitation so extended has now been accepted — and "no inference shall be drawn from the fact that [the new Code] section 249 . . . does not apply" to repurchases made before the effective date.71

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66 Tax Reform Act § 414(a), I.R.C. § 249(a).
67 Id.
69 307 F.2d 745 (7th Cir. 1962), rev'd 37 T.C. 23 (1961).
71 Tax Reform Act § 414(c). See H.R. Rep. 413, pt. 1, at 111. The Treasury, in recom-
If the previous tax rule (or uncertainty) had a nexus to the merger affliction, it was not an obvious one. To be sure, all conglomerates sooner or later seem to produce convertible issues, what is issued may in due course be repurchased, and it may, when this happens, fetch a premium. But is this the kind of thing that makes Jimmy (Ling, that is) run? The ability at some future date to deduct more than the Service regards as proper on account of debt repurchases seems hardly to be of great utility to anybody.

**THE STOCK DIVIDEND PROVISIONS**

At the outset, it was suggested that some parts of the Act not expressly aimed at conglomerates might, in the long run, prove more damaging to the movement than those bearing the anti-conglomerate label. There is some evidence that the conglomerateurs share this conviction. Among the angry multitude appearing before the Finance Committee, there was only one witness representing a well-known conglomerate whose testimony achieved wide publicity. This was Glenn McDaniel, Chairman of the Executive Committee of Litton Industries. He appeared on September 17th, and attacked, not the sections discussed above, but rather section 421, entitled "Stock dividends," which makes a rather sweeping change in Code section 305.72

As Code sections go, 305 was — in the good old days before December 30, 1969 — rather simple. It said that all distributions (with two minor exceptions) to the shareholders of a corporation in stock, or rights to acquire the stock, of such corporation were not includible in those shareholders' incomes. The only distributions of this type that did constitute income were (a) those made to pay preference dividends for the corporation's current or immediately preceding taxable year, and (b) those in lieu of which the shareholder had an election to take property.

To change anything of such purity is inevitably to make it complex, and probably obscure. What Congress has done seems to have both of these results.

The Reform Act does not alter the pattern of section 305. It retains a general rule subject to specific exceptions. Unless "otherwise provided," dividends taking the form of stock of the paying corporation, or rights to acquire such stock, continue to be excluded from gross income. But now much more will be otherwise provided. In its new form, section 305 declares that its general rule will not apply, and the rules of section 301 will apply, to any distribution by a corporation of its own stock which

1. at the election of any of the shareholders, is payable either in such stock or in property;
2. "has the result of" the receipt of property by some shareholders, and an increase in the proportionate interests of others;

mending the provision, had taken the position that, since it would be merely declaratory of existing law, it should apply retroactively. U.S. TREAS. DEP'T., supra note 46, at VI-7. 72 Tax Reform Act § 421, I.R.C. § 305.
“has the result of” a receipt of preferred stock by some common shareholders, and of common stock by other common shareholders;

(4) is made with respect to preferred stock and does not have as its sole purpose preventing a dilution of conversion rights of such stock by reason of a stock dividend or stock split with respect to the stock into which the preferred is convertible; or

(5) consists of convertible preferred unless the Secretary is satisfied that it will not have the same effect as the second of the above cases. 73

In addition, the section now requires the issuance of regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction. 74

And, finally, as used in all of the foregoing, the term “shareholder” is deemed to include “a holder of rights or of convertible securities.” 75 In other words, for example, changes in the rights of the holders of convertible debentures may now result in the realization either by such holders, or by other investors, of dividend income.

In recommending legislation along these lines, the Treasury argued that, since 1954, “some corporations have used various devices which achieve substantially the same results as obtained by the granting of a choice to shareholders” to take their dividends either in stock or in property. Presumably these “devices” gave rise to no income, whereas, by express statutory provision, the choice to which they were equated would. In any event, the availability of such alternatives was said to have “led to a potential substantial revenue loss and to inequities among the recipients of corporate dividend distributions.” 76

It is not at all clear why the Treasury wanted this change in the law. The amended version of Regulations section 1.305-2 (first proposed in 1956, but promulgated only early in 1969) 77 seemed elaborate enough to reach almost any abuse. Consider, for example, this sweeping view of the 1954 statute:

Section 305(b)(2) refers to every election, whether express or implied, regardless of how or when exercised or exercisable. An election is a choice to receive payment in one medium or another. The point in time at which such choice is made, whether before or after the declaration, is immaterial

73 Id., I.R.C. § 305(b).
74 Id., I.R.C. § 305(c).
75 Id., I.R.C. § 305(d)(2).
76 U.S. Trea. Dep’t, supra note 46, at X-2.
as long as at some point in time any shareholder, either by action or inaction, has made a choice which permitted the corporation to distribute stock or stock rights with respect to some shares and money or other property with respect to other shares. . . . If some shareholders agree, expressly or impliedly, to accept distributions in stock or stock rights with respect to their common stock notwithstanding the distribution of money or other property with respect to other common stock, any distributions of stock or stock rights with respect to some but not all of the corporation's common stock would be outside the provisions of section 305(a). . . . Where a corporation having two types of common stock outstanding, with respect to which dividends may be paid in stock on one type and in money . . . on the other type, makes a distribution . . . in money . . . as to one type and in stock . . . as to the other, the distribution of the stock is not under section 305(a) since, in substance, there is a choice as to the medium of payment of any distribution by virtue of the existence of the two types of common stock, shares of either of which may be exchanged for shares of the other under section 1036 without recognition of gain or loss.78

One almost wonders if wanting more was not evidence of doubt that the regulation really did state the law.

The new section 305 does go well beyond the regulations. In adopting it, Congress accepted the Ways and Means Committee rationale that, however much naughtiness might have been foreclosed administratively, the 1954 liberalization in the stock dividend rules had encouraged other hanky-panky that must also be stopped.79

The McDaniel testimony disputed this premise. Evidence was adduced tending to show that, since 1954, there had been no general turn by corporations to devices of the type condemned, nor any real increase in either the value of stock dividends or their use as a substitute for cash. It was noted that high-bracket taxpayers, whatever the fate of the proposed amendment, would still be able to concentrate their investments in low or zero yield growth shares—even within a corporation which had other shareholders receiving generous cash payouts. And the point was made that, conceding the need for disallowing such an option, the proposals restored the fearsome complexity of the pre-1954 proportionate interest test, interfered with perfectly legitimate capital arrangements, discriminated against common stockholders, and raised serious constitutional questions. All in all, Mr. McDaniel saw the proposal as a needless and costly addition to the law.80

Anyone aware of the history of Litton Industries will understand Mr. McDaniel's concern. Since 1959, the corporation has paid no cash dividends to its common stockholders. The only thing these people have received has

80 Senate Hearings 2277 passim. Mr. McDaniel seemed also to be hinting at a conspiracy: his prepared statement contained a reproachful reference to the recommendations for revision of § 305 made by the great "subchapter C Advisory Group." Id. at 2282. See Subchapter C Advisory Group, House Comm. on Ways and Means, Revised Report on Corporate Distributions and Adjustments 14-16 (Comm. Print 1958).
been more stock. At the same time, an aggressive acquisition program has been going on. Both convertible debentures and convertible preferred stock have been issued in this connection. In negotiating the terms of such issues,

a prime objective . . . is to minimize the dilution of the interests of its common shareholders should conversion occur . . . when possible, by trying to obtain the right to pay annual stock dividends to the common stockholders without having to adjust the rate of conversion in the convertible stock or security or by periodically increasing the conversion price.81

Litton's "Series B" convertible preferred was created in just such a negotiation. Used as consideration in several mergers, it is designed to accommodate, on the one hand, the desires of stockholders of the acquired corporations for cash dividends and for a chance to participate in Litton's growth; and, on the other, Litton's insistence that these shareholders not have the benefit of both cash dividends and (through a conversion right) the stock dividends Litton's common stockholders are getting. The preferred provides, therefore,

that its conversion rate will be increased only if and to the extent that the value of stock dividends distributed on the common in any year exceeds the cash per share payable on the preferred; and that its conversion rate will decrease if in any year the value of the stock dividends on the common is less per share than the cash dividend rate for the preferred.82

Since this highly sophisticated issue first appeared, market fluctuations in the value of Litton's common stock have several times changed the preferred's conversion ratio. It has gone up, and it has gone down. Had the Reform Act then been the law, each decline in the ratio would have resulted in a realization of income by the holders of the common stock—even though, as Mr. McDaniel stressed, no conversion might ever occur and though conversion, if effected, might well be at the original rate. Moreover, while imputing income when a conversion rate goes down, the provision would impute no loss when the rate goes up. All of this Mr. McDaniel thought "bizarre."83

Litton's tender concern for its stockholders may be unusual. The results that flow from it in the form of changes in conversion ratio are not. The stockholders of other corporations will also have problems under the new version of section 305, some of which will be rather odd.

In a recent private placement, the institutional investor bought a package consisting of common stock and warrants, exercisable for at least seven years, to buy still more common. The warrants stated an "initial purchase price" for the additional stock, but then provided:

81 Senate Hearings 2286.
82 Id. at 2286-87.
83 Id. at 2287.
If, however, the "earnings per share" ("EPS") of the Company . . . for 1969 . . . is less than [the amount specified for that year] the Initial Purchase Price shall be reduced by $10, . . . [and by lesser amounts for EPS shortfalls in later years].

If the EPS for any year . . . is less than the [specified amount] . . . then for each 1¢ of EPS below . . ., [the warrant-holder], at its option, shall receive warrants to purchase an additional 445 shares of the Company's Common Stock at the Purchase Price then in effect, and such Warrants shall be entitled to the same rights and benefits as provided herein.

From the outset the warrants were freely transferable and independent of the stock with which they had been purchased. However, the special rights to reductions in the warrant price or to receive additional warrants

shall not inure to or be enforceable by any holder of a Warrant other than [the original purchaser] or any transferee of [the original purchaser's] entire interest in the warrants.

It would be downright fascinating to watch the Secretary — or his delegate — wrestling with this problem as he composes the regulations that the Act contemplates. If the original purchaser were to dispose of all its warrants, and if earnings per share did fall short, should anybody be charged with income as the warrant price went down and the number of warrants increased? Or is this a case that can be tackled only with further legislation?

Of even more pressing concern, however, is what the forthcoming regulations will say about the less ingenious transactions that are part of the daily grind. Suppose a corporation has outstanding a conventional issue of cumulative preferred stock entitled to a liquidating preference (or a call price) of "par plus accrued dividends." If one of the preferred dividends is passed, will this result in such a "change in redemption price" as to constitute a constructive dividend to the preferred shareholders? And if the corporation later makes up the arrearage, will the payment (a "distribution to which section 301 applies") so increase the common stockholders' proportionate interests as to put them in receipt of dividends then?

The Section of Taxation of the American Bar Association excepted to Bill section 421 on broader grounds than those offered by Mr. McDaniel, but with equal vehemence.

Many problems . . . are dealt with only by creating a broad authority to tax and leaving it to the Secretary or his delegate to develop specific rules. This method . . . will likely leave the law in an unfortunate state of uncertainty for years to come. Moreover, the bill would aggravate the present lack of coordination and integration of the treatment of stock dividends with other areas of subchapter C, such as the rules concerning redemptions, liquidation, recapitalizations and section 306 stock. Any regulations issued under proposed section 305 and revised regulations under section 306 are certain to be even more complex than the statute. . . .

It is recommended that modification of section 305 be deferred and be
made a part of and integrated with a more comprehensive technical revision of subchapter C of the Code. 84

A somewhat more restrained, but equally definite, criticism was offered by the Committee on Taxation of the Association of the Bar of the City of New York. 85 On the other hand, the new rules were endorsed by the Commerce and Industry Association of New York, 86 and the American Institute of Certified Public Accountants. 87 The last approval was particularly surprising in view of the Institute's earlier opposition to the section 305 regulations. 88

All the spirited protest proved unavailing. The new rules will apply to distributions with respect to, or increases in the conversion ratio of, all stock issued on or after January 10, 1969, or, in those cases where amended section 305 regulations (promulgated on that date) do not apply, on or after April 22, 1969. But the holders of shares issued prior to one or the other of those dates will not begin to feel any effect until January 1, 1991. 89

The Treasury's hopes for a radical revision of section 305 seem to have been well-founded. Exciting forms of capitalization developed since 1954, or more prevalent than they had been, will hereafter, at the very least, be open to question. The change in this aspect of the law will not bring the conglomerate bandwagon to a screeching halt, but it may markedly transform particular incidents of the operation. Not all of these have been tax-motivated.

WHAT ELSE COULD CONGRESS HAVE DONE?

Rehearsal of the Litton arguments against the section 305 amendments illustrates the problems created for the conglomerates, perhaps without conscious design, by the Tax Reform Act, but does not exhaust them. The Tax Reform Act went further to stem the merger tide than the reports of either of the tax-writing committees admitted. The stock dividend provision is only one of the ways in which it did so.

But this is not to say that either that provision, or anything else in the Act, would absolutely bar future acquisitions. Even in this narrow and highly technical area, tax reform is less than total. And if the aim was truly to eliminate all of "the features of the tax laws which . . . provide a special and unwarranted inducement to mergers," 90 much, much more could have been done.

84 Id. at 5193.
85 Id. at 1624.
86 Id. at 4742.
87 Id. at 4801.
89 Tax Reform Act § 421(b).
Perhaps the starting point for any effort along these lines should be to eliminate some discrimination. The argument has been made, not altogether in jest, that the tax law promotes economic concentration through detriments rather than benefits. "[T]he Government," in Gustave Simons' opinion, "is doing its best to compel corporations to merge."\footnote{Letter to the Financial Editor, N.Y. Times, Nov. 25, 1969, § 3, at 17, col. 2.} He supports this charge by citing the following pressures upon small businesses and their owners:

1. heavy estate taxes, made heavier through inflated valuations of stock not publicly traded, and impossible to provide for because of the section 264 limitations on deductions for interest incurred to purchase life insurance;
2. the minute scrutiny of small corporation entertainment expenses, a trial to which big companies are seldom subjected;
3. the tax on unreasonable accumulations which, it is alleged, has never been invoked against a major publicly-held corporation; and
4. the severe application, in the case of small companies, of the reasonableness test for salaries.

But these are only part of the story. Mr. Simons says, "[t]here are innumerable other provisions of the Internal Revenue Code and administrative practices of the Internal Revenue Service which are prejudicial to small corporations."\footnote{Id.} His message is loud and clear: if you don't stop pushing the little guys around, they'll all let themselves be gobbled up by the giants.

There is something, but not very much, to be said for this view. Nevertheless, it may have been in deference to it that the Senate Finance Committee made one of its numerous additions to the Reform Bill. Endorsed by the Conference and enacted, this amended Code section 537 (defining the business needs for which accumulations are deemed reasonable) to permit the retention, in the year of a stockholder's death and thereafter, of the amount necessary to effect a section 303 redemption of his holdings.\footnote{Tax Reform Act § 906, I.R.C. § 537(a) (amend.) applicable to the Section 581 tax with respect to years ending after May 26, 1969.} Only a fantastic imagination will perceive a causal connection between this provision and the anti-merger syndrome.

Turning to the benefits that induce mergers, the obvious point of attack is the nonrecognition of gain in reorganization exchanges. As already noted, the most frequently used method of acquisition is a trade of stock of the acquiring corporation for the stock or assets of the acquiree. Such a transaction can, without too much distortion, be tax-free and it usually is. The question is whether it always should be. The staff of the FTC does not think so.

The special treatment of gain realized through acquisition is something of an anomaly in our tax laws. Congress has generally been loath to grant exemptions from the general principle that gains arising out of an
exchange transaction are taxable at the time of the exchange. In an economy where decentralized decision-making is prized and competition is the prime regulator, it is unfortunate that the most sweeping provisions in our tax code involving tax exemption in exchange transactions relate to mergers and acquisitions. Many business transactions and substantial amounts of otherwise taxable gains and losses are involved.94

For this reason, the staff insists that whenever the consideration given in an acquisition takes the form of marketable securities, the gain realized by the recipients of such securities should be recognized and subjected to tax.

This, by and large, was the position taken as early as 1957 by Jerome Hellerstein. In his view, "[t]he reorganization provisions entered the income-tax law . . . to effectuate the innocent purpose of dealing with mere 'changes in form and not in substance.'"95 Such a purpose would not support the present grant of across-the-board nonrecognition. The receipt of publicly-traded stock or securities is the equivalent of a receipt of cash and this is hardly a change in form only.96

A less drastic approach might be the implementation of the rule, or a variant thereof, long contained in the regulations, that a tax-free reorganization "must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise."97 This could be interpreted to require recognition whenever the reorganization exchange involves, for either or both of the corporate parties, a change in the type of business conducted.

At one time, the Service so construed it. Revenue Ruling 56-330 held that there had been no reorganization when the stockholders of three corporations transferred all their stock to a newly-organized entity in return for all of the stock of the latter.98 But this view was rejected in Bentsen v. Phinney,99 where the court asserted that the law required only that the surviving corporation continue in some business. Consequently, Revenue Ruling 56-330 was revoked in 1965 and the National Office conceded that the "surviving corporation need not continue the activities conducted by its predecessors."100

In the light of such a history, legislation would clearly be required to reinstate the principle, especially if there were any thought of extending it as might be deemed necessary. The corner garage absorbed into General Motors might continue to operate the same old business, but its former owner, basking at Mallorca on his GM dividends, cannot be said to have much of a continuing interest in the same kind of business he once had.

96 Id. at 291-92.
97 Treas. Reg. § 1.368-1(c) (1955).
100 Rev. Rul. 29, 1968-1 CUM. BULL. 77.
Here, surely, and in many other cases, the economic realities that should be
determinative of tax incidence cry aloud for change.

Hellerstein's was a seminal paper. It is impossible to examine tax policy
with respect to reorganizations without weighing his remarks. His analysis
seems deficient, however, in its failure to accord due weight to some of the
detriments of reorganizations. The rules, as Elliott Manning observed, work
both ways and

are not an unmixed blessing to taxpayers . . . . They prevent the
immediate recognition of losses as well as postpone the recognition of gain,
and the fact that assets transferred in a reorganization retain their old
basis in a period of rising prices may mean that the price of nonrecognition
of gain is a lower base for future depreciation deductions. In addition, the
almost automatic treatment of boot as having the effect of a dividend may
result in more tax than if the reorganization exchange had not been given
special "limited" recognition of gain.101

These considerations impel us to ask if there are not steps, short of
recognizing gain at the instant of merger, which might still prove effective.
Convertible stock or debt has become almost a talisman of the modern ac-
quision. What would happen if conversion were made a taxable event?
Would this so disparage convertible issues as to make them no longer
useful? And in this event, would any significant number of prospective
mergers become too costly to be practicable?

The fact of the matter is that there is no statutory authority for treating
the conversion of either stock or debt as a tax-free transaction. Moreover,
the literal language of Code section 1022 would seem to require a tax. And
yet, since 1920, with respect to bonds and debentures, and 1925, in the case
of preferred stock, the Service has consistently found that no income
arises.102 Principles so ancient can scarcely be susceptible of reversal by reg-
ulation or ruling, but there seems to be no barrier to legislative correction.

We might also ponder in this connection the capital gains treatment
described in the Canadian Government's White Paper on tax reform tabled
in Ottawa on November 9, 1969. The proposal is not merely to end the
long-standing exclusion of capital gains from the incomes of Canadian tax-
PAYERS. This would be controversial enough. The government seeks also to
tax unrealized appreciation when property is transferred by gift, to provide
for a carry-over of basis at death and — most dramatic of all — with respect
to holdings of shares in widely-held Canadian companies:

Taxpayers other than widely-held Canadian corporations . . . would
be required to revalue these shares to market value every five years and
take one-half of the resulting gain or loss into account for tax purposes

101 Manning, "In Pursuance of the Plan of Reorganization": The Scope of the
Reorganization Provisions of the Internal Revenue Code, 72 Harv. L. Rev. 881, 917
(1959).

102 Fleischer & Cary, The Taxation of Convertible Bonds and Stock, 74 Harv. L.
in that year. A special rate is proposed for widely-held Canadian corpora-
tions to avoid double tax.\textsuperscript{103}

It is difficult to imagine any scheme that could more effectively take the
steam out of the merger movement than this abrupt departure from historic
realization concepts.

We have come a long way from the happy day of the “vehicle,” that
thoroughly unsuccessful corporation which was ever for sale at high price
to someone in need of its loss carryovers. Only if sale were too long delayed,
only if those carryovers “died on the vine,” could the enterprise truly fail.
Ours is a less ingenuous age. Today the vehicle is a potential conglomerate.
The Textron, Bangor-Punta and Studebaker empires were all constructed
in the shelter afforded by past disasters.\textsuperscript{104}

If more creations of this kind represent a clear and present danger, if
Congress is genuinely alarmed over what the Penn-Central may blossom into,
the means of stunting that exotic growth lie ready at hand. A flat prohibition
on the use of carryovers in all such circumstances would doubtless be suf-
ciently preventive to suit the most demanding. A less Draconian remedy
might be some expansion of the principle of Code section 382.\textsuperscript{105} It is rea-
sonable to ask, however, whether we should just let well enough alone.
There is already so much law on this subject, and the likelihood of a novel
approach is so slight, that almost any tinkering would be suspect.

But suppose, for good and sufficient reason, we do confine our attack
to the debt aspect of acquisitions. Is not more than the feeble effort of the
Tax Reform Act possible? Even Ways and Means knows that it is. H.R.
7489, introduced last February by Chairman Mills, would have limited
deductions for interest whenever more than 35 percent of the consideration
for an acquisition of stock consisted of debt instruments or of property at-
tributable to borrowing.\textsuperscript{106} As is the provision actually made law, H.R.
7489 was strangely narrow in its scope. Its terms suggested more a desire to
protect managements from hostile tender offers then a will to damp merger
fires. But this little bill would still have a greater effect on acquisitions than
new Code section 279.

**Why Does Everybody Have This Thing About Debt?**

And this leads us to the question, why do the anti-conglomerate pro-
visions of the Tax Reform Act concentrate on debt? Is there something
peculiarly evil in its use to grease the merger wheels? Or is this preoc-

\textsuperscript{103} E. BENSON, PROPOSALS FOR TAX REFORM 40-41 (1969).
\textsuperscript{104} FTC REPORT 153 \textit{passim}.
\textsuperscript{105} Compare Asimow, \textit{Detriment and Benefit of Net Operating Losses: A Unifying
Theory}, 24 Tax L. Rev. 1 (1968), \textit{with} HOUSE COMM. ON WAYS AND MEANS, SUBCHAPTER C
ADVISORY GROUP PROPOSED AMENDMENTS, \textit{As Revised} § 29 \textit{and} accompanying REVISED RE-
PORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 89-95 (Comm. Print 1958). \textit{See also
AICPA (Tax Div.), Testimony on Tax Reform Proposals Presented to House Ways and
cupation evidence of a King Charles’ Head complex, an omnipresent and, therefore, seldom pertinent consideration?

The Ways and Means Committee’s extraordinary detour into the thin capitalization morass has already been noted. The Finance Committee proved even more concerned. In addition to accepting the House’s acquisition indebtedness provision without much change, its revision of the Bill, followed in this respect by the conference substitute, included express authority for regulations to determine for all purposes of the Internal Revenue Code, “whether an interest in a corporation is to be treated . . . as stock or indebtedness.” The regulations shall set forth “factors which are to be taken into account” in the determination, and such factors may include, *inter alia*:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest,
(2) whether there is subordination to or preference over any indebtedness of the corporation,
(3) the ratio of debt to equity of the corporation,
(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.107

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107 Tax Reform Act § 415, I.R.C. § 385 (new). “It is not intended that only these factors be included in the guidelines or that with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.” S. Rep. 552, at 138. The 1956-1958 Advisory Group on Subchapter C recommended the addition to the Code of a definition of corporate indebtedness in order to provide “greater certainty . . . as a guide . . . in ordinary case.” *Subchapter C Advisory Group, House Comm. on Ways and Means, Revised Report on Corporate Distribution and Adjustments 24* (Comm. Print 1958). The definition was designed to have limited usefulness and “intended to be without prejudice to the determination of the status of other alleged obligations.” *Id.* *Subchapter C Advisory Group Proposed Amendments, As Revised, § 10* (Comm. Print 1958) provided:

indebtedness of a corporation shall include in all events . . . any unconditional obligation in writing . . . to pay on demand or before a specified and not unreasonably distant date a sum certain in money incurred upon a distribution to shareholders or for an adequate consideration in money or money’s worth and under circumstances which do not negate any reasonable expectation of payment if—

(1) the obligation is not by agreement subordinated to the claims of trade creditors generally, and
(2) payment, if any, for use of the principal amount is not excessive, is not dependent upon the earnings of the corporation, and is unconditionally due not later than the maturity date of the principal amount, and
(3) the obligation does not entitle the obligee to vote upon the election of directors of the corporation, and
(4) in case the obligation is initially held or guaranteed by a shareholder of the corporation, immediately after the obligation is created the principal amount of all obligations of the corporation held or guaranteed by its shareholders does not exceed by more than five-to-one the fair value of the outstanding stock of the corporation or the total of the capital and surplus paid-in with respect thereto, whichever is greater.
We should probably understand this grant, which can hardly transcend the general power conferred upon the Secretary in Code section 7805, as no more than a directive to regulate. But even this seems supererogatory. Although no present regulation addresses itself exhaustively to the debt-equity dichotomy, the matter has been treated by way of ruling. In his recent presentation before an American Bar Association National Institute, Commissioner Thrower adverted to Revenue Ruling 68-54, enumerating criteria for debt characterization in the case of the registered subordinated debentures issued by New York Stock Exchange member corporations.

These instruments are troublesome because their issuers habitually operate on large amounts of debt and, indeed, are permitted by Exchange rules to maintain debt-equity ratios as high as 20:1. Moreover, in determining compliance with those rules, the Exchange treats these debentures as equity. Nevertheless, the ruling holds that for tax purposes they constitute indebtedness. The attributes militating in favor of this conclusion were the following:

1. The debentures were payable within a reasonable period of time and on a fixed date;
2. Payments of principal and fixed interest were not dependent upon earnings, and additional interest that was contingent upon earnings was based on a fixed formula; although a default in interest payments would not accelerate maturity, it would give rise to a cause of action for non-payment;
3. Although the debentures were subordinated to the claims of creditors, they had priority over all classes of stock;
4. The debenture holders had no vote or management powers;
5. The debtor's capital was sufficient for normal business operations, and its earnings history made it reasonable for a debenture holder to expect to be paid;
6. On the basis of all the facts and circumstances, it appeared that the parties intended to create a debtor-creditor relationship.

The Commissioner noted also that the persons to whom these debentures were issued were "strangers with no equity in the corporation" and that the debentures were not convertible. In other words, the debenture-holders were not also stockholders, and they had no expectation of becoming stockholders at some later date.

Mr. Thrower then went on to contrast with what he called the "safe harbor" rule of Revenue Ruling 68-54, the conditions obtaining in the usual debt-financed acquisition:

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109 1968-1 CUM. BULL. 69.
110 CCH N.Y. STOCK EXCH. GUIDE Rule 325(a), ¶ 2325, at 3525 (May, 1964).
112 Rev. Rul. 54, 1968-1 CUM. BULL. 70.
114 Id.
In the usual situation the stockholders of the acquired corporation own the entire equity of a going business having a value in excess of its book value. . . . These equity holders are exchanging their equity for convertible debentures in the acquiring corporation. The convertible debentures may also be subordinated to various classes of other creditors. The face amount of the convertible debentures to be issued take into account the fair market value of the book assets as well as the other factors affecting the earning capacity of the business, including good will.

The owner of the acquired corporation is contributing his equity to the acquiring corporation on the basis of what he can bargain for in terms of face value of debentures and conversion rights. It seems probable that in today's market, the convertible debentures issued in many of the acquisitions could not have been sold for cash at their face amount . . . .

It further appears reasonable to conjecture that the historical earnings of the acquiring corporation, together with the acquired corporation, may not be adequate to service the principal of the convertible debentures, together with its interest obligations.

It would seem that at some point in conglomerate acquisitions the mere size of the convertible debentures to be issued can be relatively so large as to create a "thin" capitalization situation in the acquiring corporation . . . . Where at the conclusion of the negotiations a top-heavy debt structure results, it is difficult to see how the former owners of the acquired corporation suddenly became prudent lenders.

It may be that an extremely profitable operation and substantial growth of the combined business will be necessary to earn profits to meet the debt service imposed by the convertible debentures issued in the transaction.

Indeed, it may be that the dominant attraction of the debenture is in the right, through conversion, to participate in future growth of the conglomerate business. The holder may well be more interested in cashing in on the stock rise than in collecting a "debt."\textsuperscript{115}

On the strength of this testimony, it is evident that the Service neither needs authority to establish standards nor lacks ideas of what the standards should be. The Commissioner's encomiums for Revenue Ruling 68-54 were too pointed to be ignored.

But even if there were no administrative norms, this is hardly an uncharted sea. Thin capitalization is, to be sure, a court-made doctrine; as such, it partakes of the weakness of all such glosses on the law. Judges, not conspicuous for their espousal of monolithic constructions, have made no exception here. It is therefore impossible to draw from opinions in hundreds of cases any synthesis that is wholly consistent. Admitting this, however, does not imply that we cannot see when a corporation is thin, or that we do not know what to do about it.

If there is a problem, then, it may just be one of enforcement. The Ways and Means Committee cited Securities and Exchange Commission data to the effect that, in recent years, the largest increase in securities registrations had occurred with respect to bonds and that, toward the end of 1968,

\textsuperscript{115} Id. at J-2, J-3.
the rate of this increase had accelerated. Policing tax avoidance is always difficult when it becomes wholesale.

Moreover, without some change in the statute or regulations, it might prove impossible to attack thin capitalization in the conglomerate context. Agents capable of recognizing the malady in closely-held enterprises might not be so perceptive when auditing listed corporations with millions in publicly-traded bonds. Unhappily too, the aspect of economic muscle intrudes. The popguns the Service uses with such telling effect against corner garages are not the sort of ordinance called for when the game you stalk is Textron or ITT.

This would not be the first time the Treasury and Service have supported the enactment of new law as a substitute for effective audits, and there may be something to be said for the method. Having the rules spelled out in the Code probably does deter a fair amount of incorrect reporting that would otherwise have to be caught, if at all, by examining agents.

It may be, of course, that our law has not yet developed sufficiently to support an all-out attack on the kind of corporate paper now prevalent. The recently issued Canadian Proposals for Tax Reform would restrict interest deductions only with respect to debt payable to shareholders and then only when the ratio of such debt to equity exceeds 3:1. Our own thin capitalization doctrine is hardly more advanced. In our cases, although debt-equity ratios have been determined by reference to total debt, or to longstanding exclusion of capital gains from the incomes of Canadian tax-total funded debt, the interest deductions (or other debt incidents) disallowed have been none except those related to debt owed to shareholders. So confined, the present rules would not apply to much of today's outstanding acquisition indebtedness. The people who hold it may once have been shareholders (of the acquired corporation), but their position vis-à-vis the present issuer is that of creditors. Perhaps, catching them in the thin incorporation net will require a little more weaving than we now have.

In the circumstances of many of the conglomerates, it may be, in Commissioner Thrower's words, "difficult to see how the former owners of the acquired enterprise suddenly became prudent lenders." Indeed, they themselves, in this apocalyptic year, have learned that the market price of

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117 E.g., REPORT BY THE COMMISSIONER OF INTERNAL REVENUE ON ADMINISTRATIVE PROBLEMS UNDER PRESENT LAW RELATING TO DEDUCTION OF TRAVEL AND ENTERTAINMENT EXPENSE, in HEARINGS ON THE TAX RECOMMENDATION OF THE PRESIDENT BEFORE THE HOUSE COMM. ON WAYS & MEANS, 87th Cong., 1st Sess. 154, 163 (1961); id. at 166 (analysis of some court decisions and administrative cases). Cf. id. at 1635 (statement of Frank V. Olds, Controllers Inst. of America Comm. on Fed. Tax). But see SMITH, GENERAL BUSINESS EXPENSE WITH PARTICULAR REFERENCE TO ENTERTAINMENT, GIFT AND TRAVEL EXPENSES, in TAX REVISION COMPRENDIUM 1089-86 (Comm. Print 1959). As to the tax lawyer's function in such circumstances, see Knickerbocker, ENTERTAINMENT AND RELATED DEDUCTIONS UNDER THE REVENUE ACT OF 1962, 51 FORDHAM L. REV. 699, 659 (1963).
118 E. BENSON, supra note 103, at 78.
equity disguised as debt has precious little debt-like stability. But waiting for the courts to encounter this difficulty and react appropriately may prove less than rewarding. A legislative solution is quicker and more certain — even if it does multiply our controversies.

CONCLUSION

To the extent that the congressional tax reformers have chosen to attack the merger movement, they have moved cautiously and with limited objectives — so limited, indeed, that few taxpayers will be seriously affected. They have not attempted to rid the tax law of the provisions tending most to encourage business consolidations, or even to limit the applicability of such provisions.

In a number of instances the new Act does seem, as if by accident, to inhibit conglomerate activity. Such fortuitous effects could, in the long run, prove more important than the four sections specifically labelled as merger deterrents.

The intrusion into the congressional deliberations of the thin capitalization issue seems unfortunate. It diverts attention from major questions of tax policy and has no legitimate place in the statute. One can justify its presence only on somewhat meager enforcement grounds.

As a whole, the Tax Reform Act may move us a few faltering steps closer to tax equity. But it does nothing at all to simplify the law. Perhaps simplicity is a chimera. On the other hand, must all revisions in the Internal Revenue Code be conceived as relief acts for lawyers and accountants? It is hard to believe that our monster tax law will not some day collapse under its own inert mass.