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# A Suggested Alternative Approach to the Senate Finance Committee Staff's 1985 Proposals for Revising the Merger and Acquisition Provisions

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A SUGGESTED ALTERNATIVE APPROACH TO THE  
 SENATE FINANCE COMMITTEE STAFF'S 1985  
 PROPOSALS FOR REVISING THE MERGER AND  
 ACQUISITION PROVISIONS\*

*Samuel C. Thompson, Jr.\*\**

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## I. SCOPE

The reform of the merger and acquisition provisions of the Internal Revenue Code has again become one of the issues of the hour.<sup>1</sup> The issue over the years has been addressed by many commentators and groups,<sup>2</sup> including the man in whose honor this symposium is dedicated, Professor Edwin S. Cohen.<sup>3</sup>

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<sup>1</sup> The persistence of this issue throughout the years is illustrated by the following quotation from a 1938 law review article: "With federal tax reform the issue of the hour, [the] problems [with the reorganization provisions] move into sharp focus." Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 Colum. L. Rev. 98 (1938).

<sup>2</sup> See, e.g., Staff of Joint Comm. on Tax'n, *Taxation of Hostile Takeovers and Mergers* (pamphlet prepared for Senate Finance Committee April 22, 1985); Staff of Joint Comm. on Tax'n, *Federal Income Taxation of Mergers and Acquisitions* (pamphlet prepared for House Ways and Means Subcommittee on Oversight and Select Revenue Measures April 1, 1985); House Comm. on Ways and Means, 86th Cong., 1st Sess., *An Approach to Subchapter C, 3 Tax Revision compendium* 1619 (Comm. Print 1959) (Brown); Advisory Group on Subchapter C to House Comm. on Ways and Means, 85th Cong., 2d Sess., *Revised Report on Corporate Distributions* (Comm. Print 1958); ABA Comm. on Corporate Stockholder Relationships, *Tax Section Recommendation No. 1981-5, To Amend the Internal Revenue Code of 1954 To Simplify, Redefine and Make More Uniform the Various Forms of Acquisitive Corporate Reorganizations*, 34 Tax Law. 1386 (1981) [hereinafter cited as ABA Reorganization Recommendations]; ABA Tax Section, *Task Force Report, Income Taxation of Corporations Making Distributions With Respect to Their Stock*, 37 Tax Law. 625 (1984); American Law Inst., *Federal Income, Estate and Gift Tax Project, Income Tax Problems of Corporations and Shareholders, Report of Working Views* (1958) [hereinafter cited as 1958 ALI Report]; American Law Inst., *Federal Income Tax Project* (1951); Blum, *Corporate Acquisitions under the Income Tax: Another Approach*, 50 Taxes 85 (1972); Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90 (1977); Hellerstein, *Mergers, Taxes, and Realism*, 71 Harv. L. Rev. 254 (1957); Jacobs, *Reorganizing the Reorganization Provisions*, 35 Tax L. Rev. 415 (1980); N.Y. State Bar Ass'n, *Report on the Ancillary Tax Effects of Different Forms of Reorganizations*, 34 Tax L. Rev. 475 (1979); Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. Pa. L. Rev. 1335 (1985); Surrey & Warren, *The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers*, 66 Harv. L. Rev. 1161 (1953).

<sup>3</sup> See, e.g., Cohen, *Impact of Proposed Changes in Subchapter C*, 22 San Diego L. Rev.

The genesis of the most recent interest in reform of these provisions is the American Law Institute's proposals entitled *Corporate Acquisitions and Dispositions* ("ALI Proposals"), which were published in 1980 as part of the Institute's *Federal Income Tax Project, Subchapter C*.<sup>4</sup> The ALI Proposals generated a study of this topic by the Staff of the Senate Finance Committee. In 1983, that Staff published a committee print entitled *The Reform and Simplification of the Income Taxation of Corporations* ("1983 SFC Original Proposals"),<sup>5</sup> and in May 1985, the Staff published a final report entitled *The Subchapter C Revision Act of 1985* ("Proposals" or "1985 SFC Proposals").<sup>6</sup> Neither the Treasury Department's November 1984 tax reform proposals<sup>7</sup> nor the President's 1985 tax reform proposals<sup>8</sup> contain any suggestions for the reform of the merger and acquisition provisions. However, the Tax Reform Bill of 1985,<sup>8,1</sup> which was passed by the House and is now

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319 (1985); Cohen, Silverman, Surrey, Tarleau & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 Harv. L. Rev. 393 (1955); Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Colum. L. Rev. 1 (1952).

<sup>4</sup> American Law Inst., Federal Income Tax Project, Subchapter C (W. Andrews, Reporter) (1980) [hereinafter cited as the ALI Proposals]. For a description of these proposals when they were in draft form, see Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 Tax Law. 743 (1980); see also Wolfman, "Continuity of Interest" and the American Law Institute, 57 Taxes 840 (1970).

<sup>5</sup> Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations* (Comm. Print 1983) [hereinafter cited as the 1983 SFC Original Proposals]. The Senate Finance Committee had a draft bill, dated December 30, 1983, that would have implemented these proposals. This draft was reported in the January 9, 1984, issue of Tax Notes as Document 84-186. For a description of this draft bill, see Thompson, *A Comparison of the Merger and Acquisition Provisions of Present Law with the Provisions in the Senate Finance Committee's Draft Bill*, 22 San Diego L. Rev. 171 (1985).

Senate Finance Committee hearings were held on the 1983 proposals on October 24, 1983. See *Reform of Corporate Taxation: Hearings before the Senate Comm. on Finance*, 98th Cong., 1st Sess. (1983) [hereinafter cited as 1983 Senate Hearings]. A conference on these provisions was held at the University of San Diego Law School in April 1984. See 22 San Diego L. Rev. No. 1 (1985) [hereinafter cited as San Diego Proceedings].

<sup>6</sup> Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *Final Report on Subchapter C, The Subchapter C Revision Act of 1985* (Comm. Print 1985) [hereinafter cited as Proposals or 1985 SFC Proposals].

<sup>7</sup> Treasury Dept. Report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth* (1984).

<sup>8</sup> The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (1985).

<sup>8,1</sup> H.R. 3838.



(May 1986) before the Senate, would make certain changes in the tax treatment of the target corporation in taxable acquisitions and liquidations, and Senator Packwood, Chairman of the Senate Finance Committee, in his tax reform proposals,<sup>8,2</sup> suggested that the 1985 SFC Proposals be adopted substantially in their current form. Although the Senator's suggestion was rejected by the Finance Committee,<sup>8,3</sup> the House provision will have to be addressed at the Conference.<sup>8,4</sup> Thus, the issues considered here are currently before Congress.

Although both the ALI Proposals and the 1985 SFC Proposals deal with corporate taxation issues in addition to the reform of the merger and acquisition provisions, the focus of this paper is only on the reform of the basic merger and acquisition provisions, specifically the treatment of taxable acquisitions under sections 331 through 341 and nontaxable reorganizations under sections 354 through 368. To the extent they are related to merger and acquisition issues, this paper also considers the taxation of distributions under section 311 and of corporate organizations under section 351. This paper deals only generally with nonacquisitive reorganizations and bankruptcy reorganizations and does not deal at all with the carryover of losses and other tax attributes after an acquisition.

The 1985 SFC Proposals retain, albeit under different provisions, the current treatment of recapitalizations, mere changes in form, and bankruptcy reorganizations. Also, the current investment company provisions are retained but expanded. Although the divisive reorganization under section 368(a)(1)(D) is eliminated, the 1985 SFC Proposals explain that "[i]t is intended . . . that a transaction qualifying under current law as a divisive 'D' reorganization will be treated as a section 351 transaction followed by a distribution under section 355."<sup>9</sup>

Section II of this paper provides a summary of the current, proposed, and suggested alternative treatment of taxable and nontax-

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<sup>8,2</sup> Tax Reform Proposals in Connection with Committee on Finance Markup (March 18, 1986).

<sup>8,3</sup> See Joint Comm. on Tax'n, Summary of Tax Reform Provisions in H.R. 3838 (1986).

<sup>8,4</sup> For a description and analysis of the House and Senate proposals, see Thompson, *An Analysis of the Proposal to Repeal of General Utilities with an Escape Hatch*, Tax Notes June 16, 1986, at 1121.

<sup>9</sup> 1985 SFC Proposals, *supra* note 6, at 213.

able acquisitions and the reasons given for the attempted reform of this area of tax law. Section III discusses (1) the 1985 SFC Proposals' rejection of the reorganization approach, (2) the proposed definition of a Qualified Stock Acquisition ("QSA") and a Qualified Asset Acquisition ("QAA") and how this proposed system would operate in the reorganization area, and (3) a suggested alternative approach to the reorganization concept. Section IV describes how taxpayers involved in a reorganization would be treated under the 1985 SFC Proposals and the alternative approach. Section V discusses the treatment of regular liquidations under the 1985 SFC Proposals and the alternative approach. Section VI discusses how the sale of a corporation's assets followed by a liquidation would be treated under the 1985 SFC Proposals and the alternative approach. Section VII discusses the treatment of the purchase of a target's stock under the 1985 SFC Proposals and the alternative approach. Finally, Section VIII concludes that the SFC Proposals should be rejected and argues that the suggested alternatives would be more effective in solving the current problems in this area of the tax law.

## II. SUMMARY OF CURRENT, PROPOSED, AND SUGGESTED ALTERNATIVE TREATMENT OF TAXABLE AND NONTAXABLE ACQUISITIONS

### A. *Summary of Current Treatment of Nontaxable Acquisitions*<sup>10</sup>

In a tax-free acquisition, the target is acquired in a transaction in which stock of the acquiror is a substantial portion of the consideration paid. These transactions are defined as "reorganizations" and are set forth in section 368 of the Code. To qualify as a reorganization there must be continuity of interest<sup>11</sup> (*i.e.*, the target's shareholders must receive a stock interest in the acquiror),

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<sup>10</sup> The description of current law in this paper is taken from Thompson, *supra* note 5, at 171.

<sup>11</sup> Reorganizations under current § 368(a)(1)(B) and (C) and triangular reorganizations under current § 368(a)(2)(E) have statutorily mandated continuity-of-interest requirements. In addition, courts also have imposed a nonstatutory continuity-of-interest requirement for all § 368(a) reorganizations. *See, e.g., Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935) (stock interest received must be "definite and material" and a substantial part of the value of the thing transferred).

continuity of business enterprise<sup>12</sup> (*i.e.*, a continuation of a business previously conducted by the target), and a business purpose for the transaction.<sup>13</sup>

In a reorganization, the target's shareholders receive nonrecognition treatment on the exchange of their target stock or securities for stock or securities of the acquiror.<sup>14</sup> If the target's shareholders receive other property (*i.e.*, boot) they recognize gain to the extent of the boot,<sup>15</sup> and the gain is treated as a dividend if the transaction has the "effect of the distribution of a dividend."<sup>16</sup> The target and the acquiror generally have nonrecognition treatment,<sup>17</sup> with the acquiror taking a carryover basis in the target's assets.<sup>18</sup>

There are eight basic forms of tax-free acquisitive reorganizations:

1. *Direct Merger.* The merger of the target into the acquiror where at least fifty percent of the consideration paid consists of stock of the acquiror.<sup>19</sup> Although the statute does not set forth a stock requirement, courts have held that there is a continuity-of-interest requirement,<sup>20</sup> and the Service's current ruling policy is that at least fifty percent of the consideration paid in a direct merger must be stock of the acquiror.<sup>21</sup>

2. *Forward Subsidiary Merger.* The merger of the target into a subsidiary of the acquiror, where at least fifty percent of the consideration paid consists of stock of the acquiror.<sup>22</sup>

3. *Reverse Subsidiary Merger.* The merger of a subsidiary of the acquiror into the target, where the acquiror acquires "control" of the target in exchange for voting stock of the acquiror.<sup>23</sup>

4. *Direct Stock-for-Stock Acquisition.* The acquiror acquires

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<sup>12</sup> See Treas. Reg. § 1.368-1(d).

<sup>13</sup> See, *e.g.*, Treas. Reg. § 1.368-1(b); *Gregory v. Helvering*, 293 U.S. 465 (1935).

<sup>14</sup> I.R.C. § 354(a).

<sup>15</sup> *Id.* § 356(a)(1).

<sup>16</sup> *Id.* § 356(a)(2).

<sup>17</sup> *Id.* §§ 361, 1032.

<sup>18</sup> *Id.* § 362.

<sup>19</sup> *Id.* § 368(a)(1)(A).

<sup>20</sup> See, *e.g.*, *Helvering v. Minnesota Tea Co.*, 269 U.S. 378 (1935).

<sup>21</sup> See Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568. This is only ruling policy and does not necessarily set the limits of the law.

<sup>22</sup> I.R.C. § 368(a)(2)(D). The forward subsidiary merger has the same continuity-of-interest requirement as the direct merger. See Treas. Reg. § 1.368-2(b)(2); Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568.

<sup>23</sup> I.R.C. § 368(a)(2)(E).

“control” of the target in exchange “solely” for voting stock of the acquiror.<sup>24</sup>

5. *Subsidiary Stock-for-Stock Acquisition.* A subsidiary of the acquiror acquires “control” of the target in exchange “solely” for voting stock of the acquiror.<sup>25</sup>

6. *Direct Acquisition of Target's Assets.* The acquiror acquires “substantially all” of the target's assets in exchange for voting stock of the acquiror.<sup>26</sup> The acquiror may assume liabilities of the target,<sup>27</sup> subject, however, to the “boot relaxation rule,” which limits the amount of money or other property (including the assumption of liabilities) that can be paid by the acquiror to twenty percent of the value of the target's assets.<sup>28</sup> Pursuant to the plan of reorganization, the target must distribute the stock, securities, and other property it receives, as well as its other properties.<sup>29</sup>

7. *Subsidiary Acquisition of Target's Assets.* A subsidiary of the acquiror acquires “substantially all” of the target's assets in exchange for voting stock of the acquiror.<sup>30</sup>

8. *Over and Down.* After any of the acquisitions above, the target's stock or assets, as the case may be, are pushed down to a subsidiary.<sup>31</sup>

To summarize, if an acquisition of a target by an acquiror or a subsidiary of the acquiror satisfies any of the eight forms of acquisitive reorganizations, the following tax treatment will result. The target's shareholders have nonrecognition treatment except to the extent they receive boot, in which case gain realized is recognized to the extent of the boot, and the recognized gain may be a dividend if the transaction has the effect of a dividend. The target has nonrecognition treatment. The acquiror and the subsidiary of the acquiror have nonrecognition treatment, and take a carryover

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<sup>24</sup> *Id.* § 368(a)(1)(B).

<sup>25</sup> *See id.* (parenthetical clause). This is another form of a “B” reorganization. Consequently, the requirements for this type of acquisition are virtually the same as those for the direct stock-for-stock acquisition.

<sup>26</sup> I.R.C. § 368(a)(1)(C).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* § 368(a)(2)(B).

<sup>29</sup> *Id.* § 368(a)(2)(G).

<sup>30</sup> This is also a “C” reorganization. *Id.* § 368(a)(1)(C) (parenthetical clause). The requirements for this type of reorganization are essentially the same as those for a direct acquisition of the target's assets.

<sup>31</sup> *Id.* § 368(a)(2)(C).

basis in the target's assets.

### B. Summary of Current Treatment of Taxable Acquisitions

There are three basic patterns of taxable acquisitions under current law: a purchase of the target's assets, followed by the liquidation of the target under section 337; a purchase of the target's stock, possibly followed by an election under section 338 by the acquiror to treat the stock acquisition as if there had been a purchase of the target's assets; and the liquidation of the target followed by a sale of the assets to the acquiror by the target's shareholders. The third pattern is used much less often than the first two. Also, the third pattern gives rise to the question, under the *Court Holding*<sup>32</sup> and *Cumberland Service*<sup>33</sup> doctrines, whether the corporation or the shareholders made the sale. However, even if the shareholder sale is imputed to the corporation, the transaction should qualify under section 337 and the tax results would be the same as under the direct acquisition pattern, assuming an election under section 333 has not been made.<sup>34</sup>

In each of these patterns, the tax treatment to the selling shareholders, to the target, and to the acquiror is essentially the same, assuming that in a stock acquisition the acquiror makes the election to treat the transaction as a purchase of assets, and assuming that the target is not a collapsible corporation. In such situations, the selling shareholders have a capital gain upon either (1) the receipt of the sales proceeds upon the liquidation of the target after a direct sale of the target's assets, (2) the sale of their stock, or (3) assuming that section 333 is not applicable, on the receipt of the target's assets in liquidation in anticipation of sale. In the case of a liquidation prior to sale, the target's shareholders take a fair mar-

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<sup>32</sup> *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (nominal sale by shareholders was in fact a sale by the distributing corporation).

<sup>33</sup> *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950) (sale by shareholders was not imputed to distributing corporation).

<sup>34</sup> For an example of the disastrous tax results that can result if a sale by shareholders of property received in a § 333 liquidation is imputed to the corporation under the *Court Holding* doctrine, see *Cohen v. Commissioner*, 63 T.C. 527 (1975) (in view of liquidation under § 333 there is no protection for the imputed sale under § 337, see I.R.C. § 337(c)(1)(B), and after-tax proceeds increase earnings and profits for purposes of § 333). *But see DiAndrea, Inc. v. Commissioner*, 47 T.C.M. (CCH) 731 (1983) (although sale is imputed to corporation, § 337 treatment is available).

ket value basis for the target's assets<sup>35</sup> and, consequently, assuming no post-liquidation appreciation in value, there should be no gain or loss on the sale to the acquiror.

Except for recapture items,<sup>36</sup> section 337 provides nonrecognition treatment to the target on both the direct sale of its assets and the constructive sale of its assets under a section 338 election.<sup>37</sup> Also, the target does not recognize gain or loss (except for recapture items) under section 336 upon the distribution of its assets in liquidation.<sup>38</sup>

In a direct purchase, the acquiror takes a cost basis in the target's assets, and when the acquiror purchases the target's stock and makes a section 338 election, the target takes a cost basis for its assets. In each of these transactions the acquiror gets the benefit of a step-up in basis without subjecting the target to taxation on its appreciated assets, except to the extent of recapture items.

The above pattern of capital gain at the shareholder level and nonrecognition (except for recapture items) at the target level is modified if the target is a collapsible corporation.<sup>39</sup> A collapsible corporation is basically a corporation that is formed or availed of by its shareholders for the purpose of producing or acquiring ordinary income property with a view to the sale or exchange by the shareholders of their stock in a capital gain transaction before the realization by the corporation of at least two thirds of the taxable income to be derived from the property. In other words, a collapsible corporation is defined in such a way as to encompass corporations that may be used by their shareholders to convert what would otherwise be ordinary income into capital gain.

If the target is a collapsible corporation, then the target is subject to full taxation in a direct sale of its assets, because the nonrecognition treatment of section 337 is not available.<sup>40</sup> Since the corporation recognizes all of its income, it is not collapsible at the

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<sup>35</sup> I.R.C. § 334(a).

<sup>36</sup> Recapture of depreciation, investment tax credits, and tax benefit items may generate ordinary income. *See id.* §§ 47, 1245, 1250; *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983).

<sup>37</sup> *See* I.R.C. §§ 337, 338.

<sup>38</sup> *See id.* § 336. This general nonrecognition treatment to the target is, in essence, the codification of *General Util. & Oper. Co. v. Helvering*, 296 U.S. 200 (1935).

<sup>39</sup> *See* I.R.C. § 341.

<sup>40</sup> *Id.* § 337(c)(1)(A).

time of the distribution to the shareholders, and they, therefore, receive capital gain on the liquidation.

The target's shareholders have ordinary income on the sale of stock of a collapsible corporation.<sup>41</sup> In a straight liquidation of a collapsible corporation, the shareholders have ordinary income on the liquidation<sup>42</sup> and take a fair market value basis in the assets.<sup>43</sup> The collapsible target has nonrecognition on the liquidation, except to the extent of recapture items.<sup>44</sup>

### C. Summary of the 1985 SFC Proposals

The 1985 SFC Proposals would repeal (1) the current eight forms of acquisitive reorganizations, (2) the current tax-free sale and liquidation provisions under section 337, and (3) the current elective step-up in basis provision under section 338, replacing them with the concept of a Qualified Asset Acquisition ("QAA") and a Qualified Stock Acquisition ("QSA").

A QAA is defined as any statutory merger or consolidation and any acquisition by an acquiring corporation of at least seventy percent of the gross fair market value ("FMV") and at least ninety percent of the net FMV of the target's assets.<sup>45</sup> Thus, a QAA encompasses the current section 368(a)(1)(A) (merger) and (C) (stock-for-asset) reorganizations and the section 337 sale of assets.

A QSA is defined as the acquisition by an acquiring corporation of control of a target corporation during a 12-month period.<sup>46</sup> Control means at least eighty percent of the total number of shares of each class of stock other than nonvoting stock that is limited and preferred as to dividends.<sup>47</sup> Thus, a QSA encompasses both the current section 368(a)(1)(B) (stock-for-stock) reorganization and the section 338 purchase-of-stock transaction. In any QSA or QAA the acquiring corporation is deemed to have made a QSA with respect to any direct or indirect subsidiary of the target.

There is no continuity-of-interest requirement in a QAA or QSA. Thus, a transaction will qualify without respect to the mix of con-

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<sup>41</sup> *Id.* § 341(a)(1).

<sup>42</sup> *Id.* § 341(a)(2)(A).

<sup>43</sup> *Id.* § 334(a).

<sup>44</sup> *Id.* § 336.

<sup>45</sup> See *infra* text accompanying note 81.

<sup>46</sup> See *infra* text accompanying note 69.

<sup>47</sup> See *infra* text accompanying notes 72-74.

sideration paid by the acquiring corporation. Since there is no limit to the mix of consideration paid, QSAs and QAAs encompass all types of multi-corporate acquisitions. Moreover, a target's stock or assets may be acquired by any member of the affiliated group of the acquiring corporation.<sup>48</sup>

A target shareholder who receives stock of the acquiror for his target stock has nonrecognition treatment without respect to the consideration paid to the other target shareholders. Also, there is no continuity of business enterprise requirement and no business purpose requirement, as currently required for a reorganization.

In any QAA or QSA the target's shareholders receive nonrecognition treatment to the extent they exchange their target stock for stock of the acquiring corporation or any of its affiliates (the "acquiring group"), or exchange securities of the target for securities of an equal principal amount of any member of the acquiring group. Thus, the basic nonrecognition rule of current section 354<sup>49</sup> is retained. Also, as is the case under current section 356,<sup>50</sup> the target's shareholders have gain recognition on the receipt of other property (*i.e.*, boot), which includes the fair market value of the excess principal amount of securities received.

The 1985 SFC Proposals also resolve the current dispute over how to determine whether the receipt of boot "has the effect of the distribution of a dividend."<sup>51</sup> The Proposals' dividend equivalency test is made by treating the transaction as if the target's shareholders had received nothing but the stock of the acquiring corporation and, immediately after the acquisition, the acquiring corporation redeemed a portion of its stock in exchange for the boot actually received by the target's shareholders. Thus, the 1985 SFC Proposals adopt the rule of *Wright*,<sup>52</sup> rejecting the approach of *Shimberg*<sup>53</sup> and of the Service.<sup>54</sup>

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<sup>48</sup> The SFC Proposals would thus abolish the rules of *Groman v. Commissioner*, 302 U.S. 82 (1937) (stock of an affiliate of the acquiring corporation received by the target shareholder in a reorganization was "other property" and not entitled to nonrecognition treatment), and *Helvering v. Bashford*, 302 U.S. 454 (1938) (following *Groman*).

<sup>49</sup> I.R.C. § 354.

<sup>50</sup> *Id.* § 356.

<sup>51</sup> *Id.* § 356(a)(2).

<sup>52</sup> *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973); see also *Clark v. Commissioner*, 86 T.C. No. 10 (Feb. 6, 1986) (following *Wright*).

<sup>53</sup> *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978).

<sup>54</sup> Rev. Rul. 75-83, 1975-1 C.B. 112.



The tax treatment of the target's shareholders in a QSA or QAA is essentially the same as in a reorganization under current law; however, if no stock of the acquiring group is received, the treatment is the same as under current section 331 in a liquidation following a section 337 sale, or under section 1001 in the case of a stock sale.

The collapsible corporation provision is repealed under the 1985 SFC Proposals; consequently, any gain recognized by the shareholders that is not a dividend is capital gain. However, a provision treats the corporation as having ordinary income on the disposition of assets which in the hands of certain shareholders would be ordinary income.

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

In a QSA, the target corporation (and each target subsidiary) takes a carryover basis in its assets unless a Cost Election is made with respect to such corporation. If the Cost Election is made with respect to the target or target subsidiary, then each corporation that makes such an election recognizes gain with respect to its assets and the basis of such assets is stepped up to fair market value. Thus, in contrast to the anti-selective step-up provisions of current section 338, there is complete selectivity under the 1985 SFC Proposals. The apparent reason for allowing this selectivity is that a corporation will have complete recognition with respect to its assets at some point in time. The acquiring corporation takes as its basis in the target's stock the net adjusted basis of the target's assets. Thus, if a Cost Election is not made, there will be a difference between the amount the acquiring corporation paid for the target's stock and its basis in such stock. There are special rules to take account of any such difference.

A target would recognize gain upon distribution of its assets in both liquidating and nonliquidating transactions; consequently, if

the target is liquidated followed by its shareholders selling the assets to the acquiring corporation, there would be complete recognition of gain at the target corporation level. Apparently, no provision allows the liquidating corporation to avoid recognition of gain on goodwill.

To reduce the effect of the corporate-level tax for certain small corporations (*i.e.*, those with a stock value of less than \$2 million) in a QAA or QSA for which a Cost Election is made, the 1985 SFC Proposals would increase the shareholder's basis in his target stock by his share of the after-tax proceeds applicable to the corporation's long-held capital assets.

#### *D. Summary of Suggested Alternative Approach*

The approach suggested in this paper would retain the current structure of merger and acquisition provisions, with the following principal changes. First, the reorganization concept would be retained, but there would be uniform continuity-of-interest and boot standards for all forms of reorganization. The continuity-of-interest test would be strengthened and its application clarified. The "substantially all" test would be revised. A reverse acquisition provision would be added. The suggested rule in the 1985 SFC Proposals for determining whether a boot distribution has the effect of a dividend would be adopted.

Second, nonrecognition treatment presently accorded under sections 311, 336, 337 and 338 would apply only to distributions, sales, or deemed sales in the context of either a partial or complete liquidation of unamortizable intangibles such as goodwill and of land and buildings used in the active conduct of the corporation's trade or business (hereinafter referred to as "actively used land and buildings"). Thus, there would be a corporate-level tax on any transfers (whether by ordinary sale, ordinary distribution, liquidating sale, or liquidating distribution) of inventory, portfolio shares, land and buildings not used in the corporation's trade or business, and equipment. Also, in any sale or liquidation transaction where the target was claiming nonrecognition treatment with respect to goodwill and actively used land and buildings, the parties would have to enter into an explicit allocation agreement that would be filed with the Service.

Section 341, the collapsible corporation provision, would be repealed; however, the 1985 SFC Proposals that would determine the

gain on certain corporate property by reference to the character the gain would have in the hands of certain shareholders would be added.

### E. Reasons for Change

The current tax treatment of mergers and acquisitions is certainly imperfect and is in need of reform and rationalization; there is no dispute about this fundamental principle. In citing the reasons for the suggested changes, the 1985 SFC Proposals say that present law is "seriously flawed" because it "lacks consistency," is "unnecessarily complex," and is "subject to manipulation."<sup>55</sup> Three interrelated reasons for change are given.

First, current law needs to be more rational and consistent, thereby providing greater certainty and less complexity.<sup>56</sup> As an example of the needless complexity, the Proposals cite the different requirements for the "A" (merger), "B" (stock-for-stock), and "C" (stock-for-asset) reorganizations under section 368.<sup>57</sup>

Second, the law should be more neutral, providing less influence over and less interference with business transactions.<sup>58</sup> As an example of the current lack of neutrality, the Proposals state that there is a bias under current law in favor of liquidation because of the special tax treatment in that situation.<sup>59</sup>

Finally, the law needs to be made less subject to manipulation, such as the possibility of multiplying losses by simply organizing subsidiaries, and the complete avoidance of corporate- or shareholder-level tax with a step-up in basis in certain acquisitions.<sup>60</sup>

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<sup>55</sup> 1985 SFC Proposals, *supra* note 6, at 37.

<sup>56</sup> *Id.* at 38.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* The 1985 SFC Proposals do not give specific examples of how these multiple losses, or tax-free acquisitions with a step-up in basis, can arise. However, presumably in the case of multiple losses, the Proposals are referring to the fact that if, for example, a parent and subsidiary corporation do not file consolidated returns, there is a possibility of a double loss deduction, one at the subsidiary level and one at the parent level as a result of the worthlessness of the subsidiary's stock. *See, e.g.,* *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977). This result can also be obtained to a certain extent even if consolidated returns are filed because of the basis adjustment provided for in the consolidated return regulations. *See, e.g.,* *Woods Inv. Co. v. Commissioner*, 85 T.C. 274 (1985). The Proposals would eliminate this problem by giving the parent a basis in its subsidiary's stock equal to its allocable share of the net asset basis of the subsidiary's assets.

The 1985 SFC Proposals go on to give eleven detailed reasons for change.<sup>61</sup> First, there is no uniform amount of boot that can be utilized in the various types of reorganizations. Second, some reorganizations have a voting stock requirement, others do not. Third, in certain cases it is possible to issue stock of a grandparent corporation and have a transaction qualify as a reorganization, but in other cases, such a transaction would be taxable. Fourth, different rules apply for forward and reverse subsidiary mergers under section 368(a)(2)(D) and (E). Fifth, there is a "substantially all" requirement in certain reorganizations but not in others. Sixth, there can be a pre-reorganization disposition of assets in an "A" or "B" reorganization but not in a "C." Seventh, there is uncertainty whether there is an overlap between a "C" and "D" reorganization. Eighth, the continuity-of-interest doctrine is "of uncertain application" and should, therefore, be eliminated. Ninth, uncertainty surrounds the parameters of the business-purpose and continuity-of-business enterprise tests and these tests should, therefore, be eliminated. Tenth, the linkage between the shareholder-level consequences and the corporate-level consequences leads to anomalous results. Eleventh, the complexity of the reorganization definition leads to whipsaw possibilities.

Although most of these stated reasons for change are sound, it is the author's position that the approach taken by both the 1985 SFC Proposals and the ALI Proposals should be rejected. The needed corrective action can be taken in much less radical steps and in a more rational and simple fashion.

The suggested elimination of the continuity-of-interest, continuity-of-business-enterprise, and business-purpose doctrines would lead to significant abuses. Although the complete elimina-

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In the case of tax-free acquisitions with a step-up in basis, the Proposals may be referring to the use of a § 351 transaction in an acquisition context where shareholders of the target owning less than 20% of the target's stock transfer their stock to a new corporation to which the acquiring corporation transfers cash in a § 351 transaction. The new corporation then uses the cash to purchase at least 80% of the target's other stock, after which the new corporation makes a § 338 election. The first step of this transaction qualifies as a good § 351 tax-free exchange under current law. See Rev. Rul. 84-71, 1984-1 C.B. 106 (revoking Rev. Ruls. 80-284, 80-285, 1980-2 C.B. 117, 119). The second step is presumably a valid § 338 transaction. The Proposals would eliminate this possibility by making § 351 unavailable in an acquisition transaction. That is, the Proposals would codify the Service's original position in Rev. Rul. 80-284 and Rev. Rul. 80-285.

<sup>61</sup> 1985 SFC Proposals, *supra* note 6, at 38-41.

tion of these concepts (principally the continuity-of-interest doctrine) might have a simplifying effect, such action would substantially erode the tax base by greatly expanding the type of exchange that would receive tax-free treatment.<sup>62</sup> Further, although the 1985 SFC Proposals would gain some simplification over current law, those proposals would themselves add considerable complexity to the Code.<sup>63</sup> On balance, in the view of the author, the apparent simplicity would not offset the increased complexity.

### III. 1985 SFC PROPOSED DEFINITION OF QAA AND QSA AND SUGGESTED ALTERNATIVE APPROACH

#### A. 1985 SFC Proposed Rejection of Reorganization Concept

##### 1. Proposed Definition of QA, QSA, and QAA

###### a. Definition of QA, Acquiring Corporation, and Target

A qualified acquisition ("QA") is defined as a QSA or a QAA.<sup>64</sup> An "acquiring corporation" is defined as a corporation that makes a QA of another corporation,<sup>65</sup> and "target corporation" is defined as any corporation the stock or assets of which are acquired in a QA.<sup>66</sup>

###### b. Definition of QSA

The proposed definitions of QSA and QAA replace both the eight forms of acquisitive reorganizations under current law<sup>67</sup> and

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<sup>62</sup> Indeed it is ironic to think that Congress, which in the Tax Reform Act of 1984 amended § 1031 of the Code (the like-kind exchange provision) to make it clear that a swap of partnership interests does not qualify for tax-free treatment, would in 1986 substantially devitalize that same like-kind exchange provision by providing that a swap of any amount of stock in a target corporation for any type of stock in an acquiring corporation can be made on a tax-free basis without respect to the nature of the other consideration paid by the acquiring corporation in making the acquisition.

<sup>63</sup> In testimony before the Senate Finance Committee with respect to the original SFC Proposals in 1983, then Deputy Assistant Secretary of the Treasury Ronald A. Pearlman stated: "We think it is a bit dangerous, however, to sell these proposals as simplification. Corporate transactions by their nature are complex, and they will continue to remain complex, we suspect. We would guess that, ultimately, the rules governing those transactions will be complex. . . ." 1983 Senate Hearings, *supra* note 5, at 9.

<sup>64</sup> Proposed § 364(a), 1985 SFC Proposals, *supra* note 6, at 112.

<sup>65</sup> Proposed § 366(b)(1), *id.* at 129.

<sup>66</sup> Proposed § 366(b)(2), *id.* at 130.

<sup>67</sup> See *supra* text accompanying notes 19-31.

sections 337 and 338 of current law.<sup>68</sup>

A QSA is defined as "any transaction or series of transactions during the 12-month acquisition period in which 1 corporation acquires stock representing control of another corporation."<sup>69</sup> A transaction can qualify as a QSA without respect to the nature of the consideration paid. The "12-month acquisition period" is the "12-month period beginning with the date of the first acquisition of stock included in the transaction or series of transactions involved in the [QSA]."<sup>70</sup> "Acquisition date" means the first day on which there is a QSA.<sup>71</sup> "Control" is defined as the ownership of stock satisfying the requirements of current section 1504(a)(2),<sup>72</sup> that is, at least eighty percent of the total voting power and at least eighty percent of the total value of the stock of the target corporation.<sup>73</sup> The current exclusion in section 1504(a)(4)<sup>74</sup> for certain nonvoting preferred stock also applies for this control test.

The Proposals provide that a reverse triangular merger of a subsidiary (direct or indirect) of the acquiring corporation into the target, where the target survives and the target's shareholders exchange stock of the target amounting to control thereof, is treated as a QSA.<sup>75</sup>

As a result of making a QSA of the target, the acquiring corporation is deemed to have made a QSA with respect to each controlled subsidiary of the target.<sup>76</sup> If as a result of a QSA of one target the acquiring corporation is treated under the attribution rules of current section 318<sup>77</sup> as owning stock of another corporation ("target sub"), then for purposes of determining whether the acquiring corporation has made a QSA of the target sub, the acquiring corporation is treated as having acquired the stock of the target sub on the acquisition date of the QSA of the target.<sup>78</sup>

The SFC Proposals provide that in applying current section

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<sup>68</sup> See *supra* text accompanying notes 32-44.

<sup>69</sup> Proposed § 364(b), 1985 SFC Proposals, *supra* note 6, at 112-13.

<sup>70</sup> Proposed § 366(a)(1), *id.* at 127.

<sup>71</sup> Proposed § 366(a)(2)(A), *id.*

<sup>72</sup> See I.R.C. § 1504(a)(2).

<sup>73</sup> Proposed § 366(c), 1985 SFC Proposals, *supra* note 6, at 130.

<sup>74</sup> See I.R.C. § 1504(a)(4).

<sup>75</sup> Proposed § 364(f), 1985 SFC Proposals, *supra* note 6, at 116.

<sup>76</sup> Proposed § 364(d)(1), *id.* at 114.

<sup>77</sup> See I.R.C. § 318.

<sup>78</sup> Proposed § 364(d)(1), 1985 SFC Proposals, *supra* note 6, at 114.

318(a)(2)(C) (which attributes to a fifty-percent or more shareholder a ratable amount of the stock held by the corporation), a corporate shareholder (parent) that controls (*i.e.*, owns eighty percent of the stock by vote and value) another corporation (sub) is deemed to own all of the stock of the sub.<sup>79</sup> The effect of this provision is that there can be a QSA with respect to a group of eighty-percent-owned subsidiaries. Thus, a QAA with respect to the target will be a QSA with respect to any direct or indirect eighty-percent-owned subsidiary of the target.<sup>80</sup>

A straight QSA is essentially the same as the straight stock-for-stock "B" reorganization under current section 368, without the "solely for voting stock" requirement and with a codification of the 12-month acquisition period specified in the legislative history of current section 368(a)(1)(B) and in Treasury Regulation section 1.368-2(c).

### c. Definition of QAA

A QAA is defined as (1) any statutory merger or consolidation, and (2) any transaction in which an acquiring corporation acquires at least ninety percent of the net fair market value ("FMV") and at least seventy percent of the gross FMV of the target's assets held "immediately before" the transaction.<sup>81</sup> The 1985 SFC Proposals explain that in determining whether the target has met the 90-70 test, prior dispositions are to be disregarded.<sup>81.1</sup> Thus, the *Elkhorn Coal*<sup>81.2</sup> case, which holds that the "substantially all" requirement for the "C" reorganization is violated where a target distributes a portion of its assets prior to a purported "C" reorganization, is rejected.

In the case of an acquisition of the target's assets described above, the target must distribute all of its assets (other than assets required to meet claims) within twelve months of the acquisition date.<sup>82</sup> Except as otherwise provided in regulations, a QAA does not include an acquisition of assets by a parent corporation from a

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<sup>79</sup> Proposed § 364(d)(2)(A), *id.*

<sup>80</sup> *Id.*

<sup>81</sup> Proposed § 364(c)(1), *id.* at 113.

<sup>81.1</sup> 1985 SFC Proposals, *supra* note 6, at 224.

<sup>81.2</sup> *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

<sup>82</sup> Proposed § 364(c)(2), *id.*

subsidiary in a current or liquidating distribution.<sup>83</sup>

The statutory merger or consolidation part of the definition of a QAA is the same as that under section 368(a)(1)(A). The "acquisition of assets" part of the definition is the same as the current stock-for-assets reorganization under section 368(a)(1)(C), but without the "solely for voting stock" requirement and the boot relaxation rules of current law.<sup>84</sup> The Proposals also codify the Service's current ruling policy that "substantially all" means ninety percent of net and seventy percent of gross assets.<sup>85</sup> As a result of the Tax Reform Act of 1984, the target in a "C" reorganization is required to distribute all of its assets pursuant to the plan of reorganization.<sup>86</sup> As with a QSA, a transaction can qualify as a QAA without respect to the nature of the consideration paid. Consequently, a sale of assets for cash under current section 337 would qualify as a QAA, provided the acquiring corporation acquired seventy percent of the target's gross assets and ninety percent of its net assets.

#### *d. Overlap Between a QAA and QSA*

If in the course of making a QAA of a target the acquiring corporation acquires from the target the stock of another corporation (target sub), and the acquisition of the stock of the target sub is a QSA, then the acquiring corporation is treated as having acquired the stock of the target sub in a QSA and the other assets of the target in a QAA.<sup>87</sup> The operative acquisition provisions apply separately to the QSA and the QAA.<sup>88</sup>

#### *e. QAA With Respect to Both Target and Target Sub*

If an acquiring corporation acquires the assets of a target sub in a QAA and also acquires the assets of the target, then the stock of the target sub held by the target is disregarded in determining

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<sup>83</sup> Proposed § 364(c)(3), *id.* at 113-14.

<sup>84</sup> See *supra* text accompanying note 28.

<sup>85</sup> Proposed § 364(c)(1)(B), 1985 SFC Proposals, *supra* note 6, at 113; see Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568.

<sup>86</sup> See I.R.C. § 368(a)(2)(G)(i), *added by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 63, 98 Stat. 494, 583.

<sup>87</sup> Proposed § 364(e)(1), 1985 SFC Proposals, *supra* note 6, at 115.

<sup>88</sup> *Id.*



whether there has been a QAA of the target.<sup>89</sup>

*f. Treatment of Recapitalizations and Mere Changes in Form as Constructive QSA and QAA*

A recapitalization is treated as a QSA,<sup>90</sup> and a mere change in form or place of organization of one corporation is treated as a QAA.<sup>91</sup>

*g. Reverse Acquisitions*

To prevent taxpayers from creating a QSA or QAA of a corporation that is not the real target corporation but rather in fact is the real acquiring corporation, the Proposals contain a "reverse acquisition" provision.<sup>92</sup> Under this provision, the Secretary is authorized to promulgate regulations dealing with situations where the shareholders of the nominal target corporation, as a result of owning stock in the target, have "control" of the acquiring corporation after the transaction. "Control" for this purpose means at least fifty percent of the vote and the value of the stock of the acquiring corporation.<sup>93</sup> The control test is made by reference to current section 1504(a)(2) except for substituting "50 percent" for "80 percent."<sup>94</sup> Presumably, there would not be a reverse acquisition if, for example, the shareholders of the target ended up with fifty percent or more of the value of the acquiring corporation's stock, but less than fifty percent of the vote. This provision would have the effect of preventing a large corporation from stepping up the basis of its assets by merging into a small corporation,<sup>95</sup> and is similar to the reverse acquisition provision of the consolidated return regulations.<sup>96</sup>

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<sup>89</sup> Proposed § 364(e)(2), *id.* at 115-16.

<sup>90</sup> Proposed § 364(g)(1), *id.* at 116.

<sup>91</sup> Proposed § 364(g)(2), *id.*

<sup>92</sup> See Proposed § 366(e), *id.* at 131.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> See *infra* notes 246-73 and accompanying text for a discussion of the Cost Election.

<sup>96</sup> See Treas. Reg. § 1.1502-75(d)(3).

*h. No Continuity-of-Interest or Business-Enterprise Requirement and No Business-Purpose Requirement*

Since there are no restrictions on the type of consideration that can be paid in a QSA or a QAA, there is no continuity-of-interest requirement. Consequently, an acquisition such as the one in *Kass*,<sup>97</sup> where most of the target's shareholders are paid in cash and only a small percentage (five percent in *Kass*) receive stock of the acquiring corporation, will qualify as a QSA or QAA. As a result, the target shareholders who receive stock will qualify for non-recognition treatment.<sup>98</sup>

Also, there is no continuity-of-business-enterprise requirement or business-purpose requirement for a QSA or QAA.<sup>99</sup>

*2. Proposed Multi-Corporate QSAs and QAAs*

The triangular stock-for-stock acquisitive reorganization under current section 368(a)(1)(B), the triangular stock-for-asset reorganization under section 368(a)(1)(C), and the forward and reverse triangular mergers under section 368(a)(2)(D) and (E) are in essence codified and broadened under the SFC Proposals. The Proposals provide that an acquisition of stock or assets of the target by more than one member of an affiliated group is treated as an acquisition by one corporation both for purposes of determining whether there is a QA and for such other purposes as are specified in regulations.<sup>100</sup> An "affiliated group" is defined as specified in current section 1504(a), without regard to the exceptions in section 1504(b).<sup>101</sup> Under section 1504, an affiliated group is essentially any chain of corporations with common stock ownership measured by eighty percent of vote and value.<sup>102</sup>

Where one member of an affiliated group itself makes a QA, that member is the acquiring corporation.<sup>103</sup> In any case where the

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<sup>97</sup> *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (per curiam).

<sup>98</sup> See *infra* notes 182-227 and accompanying text for a discussion of the tax treatment of the target shareholders under the SFC Proposals.

<sup>99</sup> 1985 SFC Proposals, *supra* note 6, at 50; 1983 SFC Original Proposals, *supra* note 5, at 59.

<sup>100</sup> Proposed § 366(a)(5), 1985 SFC Proposals, *supra* note 6, at 128-29.

<sup>101</sup> Proposed § 366(a)(3), *id.* at 127.

<sup>102</sup> See I.R.C. § 1504.

<sup>103</sup> Proposed § 366(b)(1)(B)(ii), 1985 SFC Proposals, *supra* note 6, at 129.

stock or assets of a target are acquired in a QA by multiple members of an affiliated group, the common parent of the group is deemed to be the acquiring corporation.<sup>104</sup> This rule may be overridden in certain situations by the regulations. The term "common parent" has the same meaning as in current section 1504(a).<sup>105</sup> The result of the above provisions is to permit the target's assets or stock to be acquired or held by any corporation in a group of eighty-percent commonly controlled corporations. As indicated above, a reverse triangular merger of a direct or indirect subsidiary of the acquiring corporation into the target, where the target survives and the target's shareholders exchange stock of the target amounting to control, is treated as a QSA.<sup>106</sup>

### 3. Proposed Definition of Party to the Acquisition

The term "party to the acquisition" has significance in determining the tax treatment of the taxpayers in a QSA and a QAA. It is defined to include the acquiring corporation and, where the acquiring corporation is a member of an affiliated group, the common parent of the group and any other members of the group as specified in regulations.<sup>107</sup> As explained later, this definition of "party to the acquisition" allows the target's shareholders to receive nonrecognition treatment in a QSA or QAA on receipt of the stock of the acquiring corporation or any corporation that directly or indirectly controls the acquiring corporation.<sup>108</sup> Thus, this definition, coupled with the definition of "acquiring corporation," has the effect of overriding the *Groman* and *Bashford* cases.<sup>109</sup> Consequently, the receipt of stock of an affiliated corporation rather than the acquiror may not constitute boot.

### 4. Dispositions of a Division in a QAA or QSA

The 1985 SFC Proposals would amend section 351 to allow a corporation to transfer assets into a new subsidiary in contempla-

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<sup>104</sup> Proposed § 366(b)(1)(B)(i), *id.*

<sup>105</sup> Proposed § 366(b)(4), *id.* at 130.

<sup>106</sup> Proposed § 364(f), *id.* at 116.

<sup>107</sup> Proposed § 366(d), *id.* at 130.

<sup>108</sup> See *infra* note 184 and accompanying text.

<sup>109</sup> *Groman v. Commissioner*, 302 U.S. 82 (1937); *Helvering v. Bashford*, 302 U.S. 454 (1938); see *supra* note 48 and accompanying text.

tion of the acquisition of the new subsidiary in a QAA or a QSA.<sup>110</sup> The assets transferred, however, must constitute an active trade or business.<sup>111</sup>

### *B. Suggested Alternative Approach to the Reorganization Concept*

This section first discusses various aspects of both the current reorganization definition and the proposed QAA and QSA, with a view to identifying key problem areas. It then sets out a suggested approach which rejects the Senate Finance Committee approach and its substantial modifications of the reorganization concept.

#### *1. Comments on the Current Reorganization Definition and the Proposed QAA and QSA*

##### *a. Comments on the Current Reorganization Definition*

###### *i. In General*

The current reorganization definition lacks a unifying principle. There is no tax policy justification for the disparate treatment of boot, continuity of interest, and the "substantially all" test in the various forms of reorganization. No one could justify allowing (1) fifty-percent boot in a direct merger under section 368(a)(1)(A) and in a forward subsidiary merger under section 368(a)(2)(D), (2) twenty-percent boot both in a reverse subsidiary merger under section 368(a)(2)(E) and in certain stock-for-asset acquisitions under section 368(a)(1)(C), and (3) no boot in a stock-for-stock acquisition under section 368(a)(1)(B). Similarly, there is no justification for allowing nonvoting common or preferred<sup>112</sup> stock to qualify for continuity-of-interest purposes both in a direct merger under section 368(a)(1)(A) and in a forward subsidiary merger under section 368(a)(2)(D), but requiring voting stock for continuity-of-interest purposes in each of (1) a stock-for-stock acquisition under section 368(a)(1)(B), (2) a stock-for-asset acquisition under section 368(a)(1)(C), and (3) a reverse subsidiary merger under section 368(a)(2)(E).

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<sup>110</sup> Proposed § 351(e)(1)(B), 1985 SFC Proposals, *supra* note 6, at 81.

<sup>111</sup> *Id.*

<sup>112</sup> See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

Further, it is unthinkable from a tax policy perspective that one would construct a "substantially all" test for a stock-for-asset reorganization under section 368(a)(1)(C) and for both the forward and reverse subsidiary mergers under sections 368(a)(2)(D) and (E), but no such test for the direct merger under section 368(a)(1)(A) or for the stock-for-stock acquisition under section 368(a)(1)(B).

As a result of the "substantially all" test, it is practically impossible to spin off a target's assets (either wanted or unwanted) in a tax-free transaction under section 355 prior to effectuating an acquisitive reorganization under sections 368(a)(1)(C), 368(a)(2)(D), or 368(a)(2)(E).<sup>113</sup> On the other hand, it is possible to combine a pre-acquisition spin-off by the target with a later merger under section 368(a)(1)(A) of either the distributing target into the acquiring corporation<sup>114</sup> or the spun-off controlled corporation into the acquiring corporation.<sup>115</sup> It is also possible to have a target spin off unwanted assets in a section 355 transaction prior to the acquisition of the distributing target (with its remaining assets) by the acquiring corporation in a stock-for-stock reorganization under section 368(a)(1)(B).<sup>116</sup>

In each of these strip-down transactions, both the spun-off company and the distributing company are required to continue an active trade or business in order for the spin-off to qualify for tax-free treatment to the shareholders under section 355.<sup>117</sup> In addition, the continuity-of-business-enterprise doctrine requires that the acquiring corporation continue the historical business of the target.<sup>118</sup>

Since there is no step-up in basis of the assets at the corporate level in either the spin-off<sup>119</sup> or in the subsequent acquisitive reorganization<sup>120</sup> and the shareholders of the distributing corporation

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<sup>113</sup> See, e.g., *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

<sup>114</sup> See *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

<sup>115</sup> See Rev. Rul. 75-406, 1975-2 C.B. 125; see also Rev. Rul. 76-527, 1976-2 C.B. 103 (merger of target into spun-off controlled corporation); Rev. Rul. 72-530, 1972-2 C.B. 212 (merger of target into distributing acquiring corporation).

<sup>116</sup> Rev. Rul. 70-434, 1970-2 C.B. 83; *but cf.* Rev. Rul. 70-225, 1970-1 C.B. 80 (no "B" reorganization where stock of spun-off controlled corporation acquired in a purported "B").

<sup>117</sup> See I.R.C. § 355(b).

<sup>118</sup> See Treas. Reg. § 1.362-2(d).

<sup>119</sup> I.R.C. § 362(a).

<sup>120</sup> *Id.* § 362(b).

and the target receive nonrecognition treatment<sup>121</sup> and a substituted basis<sup>122</sup> for the stock received, there is merely a deferral of the gain at both the corporate and shareholder levels. Since a "business purpose" is required for both the spin-off under section 355 and the acquisitive reorganization, this tax deferral at both the corporate and shareholder levels seems appropriate from a tax policy perspective.

In addition to tax-free strip-downs under section 355 prior to an acquisitive reorganization, there is, in general, no prohibition against taxable strip-downs in the form of dividends or redemptions prior to a section 368(a)(1)(A) or (B) reorganization.<sup>123</sup> However, in the case of section 368(a)(1)(C) and forward and reverse subsidiary mergers under sections 368(a)(2)(D) and (E), such dividends or redemptions are restrained by the "substantially all" test. From a tax policy perspective, there is no reason to prohibit such taxable strip-downs because the continuity-of-business-enterprise doctrine must be satisfied in an acquisitive reorganization. Obviously, the "substantially all" test can have a major and yet illogical impact on the structuring of acquisitive transactions. At a minimum, there should be uniform boot, continuity-of-interest, and "substantially all" requirements for each form of acquisitive reorganization.

## ii. Further Comments on the Continuity-of-Interest Requirement

The ABA Tax Section Committee on Corporate Stockholder Relationships<sup>124</sup> has recommended that the reorganization definition be amended to allow fifty-percent boot and to permit any type of stock consideration in each form of acquisitive reorganization. Also, the ABA Tax Section has suggested that stock of any corpo-

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<sup>121</sup> *Id.* §§ 354, 355.

<sup>122</sup> *Id.* § 358.

<sup>123</sup> With respect to a § 368(a)(1)(B) reorganization, see Rev. Rul. 70-172, 1970-1 C.B. 77 (dividend before a "B"); Rev. Rul. 68-285, 1968-1 C.B. 147 (redemptions of dissenting shareholders before a "B"). Compare Rev. Rul. 75-360, 1975-2 C.B. 110 (redemptions by target of stock of its shareholder prior to a purported "B" with proceeds of short-term bank loan that was repaid by acquiring corporation immediately after the purported "B" violates the solely for voting stock requirement), with *McDonald v. Commissioner*, 52 T.C. 82 (1969) (redemption by target of preferred stock with proceeds of a short-term bank loan that was repaid by acquiring corporation was held not essentially equivalent to a dividend).

<sup>124</sup> ABA Reorganization Recommendations, *supra* note 2, at 1394-95.

ration in direct or indirect control of the acquiring corporation qualify for continuity-of-interest purposes and, therefore, nonrecognition purposes.<sup>125</sup> This is similar to the suggestion in the 1985 SFC Proposals to allow members of an affiliated group to be considered a "party to the acquisition."<sup>126</sup> However, under the ABA Tax Section proposal, stock of only one corporation would qualify for continuity-of-interest purposes, whereas under the 1985 SFC Proposals stock of any of the parties to the acquisition would qualify for nonrecognition treatment.

Another area of confusion is how the continuity-of-interest doctrine under current law applies with respect to pre- and post-reorganization sales of stock. In general, pre-reorganization shifts in stock ownership do not count in considering continuity of interest; however, at least one case has held that the continuity-of-interest test must be satisfied with respect to the historical shareholders of the target.<sup>127</sup> Moreover, the Seventh Circuit recently held that a post-reorganization sale of stock of the target which was contemplated prior to the purported reorganization caused the transaction to fail to qualify as a reorganization because there was no continuity of interest.<sup>128</sup>

The ABA Tax Section has recommended that any acquisition of the target's stock by the acquiring corporation and any redemption of the target's stock within the two-year period prior to a purported reorganization be considered, in general, as boot paid in the reorganization.<sup>129</sup> Also, the ABA Tax Section has recommended that post-reorganization sales of stock not be taken into account in determining whether the continuity-of-interest test is satisfied except where stock of the acquiring corporation received in the reorganization is sold directly or indirectly to the acquiring corporation.<sup>130</sup> These suggestions have substantial merit and would significantly reduce the complexity surrounding the continuity-of-interest requirement.

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<sup>125</sup> *Id.*

<sup>126</sup> See *supra* note 107 and accompanying text.

<sup>127</sup> See *Superior Coach of Fla., Inc. v. Commissioner*, 80 T.C. 895 (1983).

<sup>128</sup> See *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

<sup>129</sup> ABA Reorganization Recommendations, *supra* note 2, at 1395.

<sup>130</sup> *Id.* at 1396.

*iii. Further Comments on the "Substantially All" Test*

The "substantially all" test was initially designed to provide resemblance between a merger transaction and a "practical" merger effectuated in the form of the acquisition of the target's assets.<sup>131</sup> However, with the developments in the law which allow a strip-down of the target in a section 368(a)(1)(A) and (B) reorganization, it is obvious from a tax policy perspective that either there is no further need for the "substantially all" test or the test should be extended to all forms of reorganization. Since there appears to be no apparent abuse associated with either tax-free or taxable strip-down transactions prior to "A" and "B" reorganizations, there seems to be no need to extend the "substantially all" concept to those forms of reorganization. Therefore, the concept should be eliminated from the forward and reverse subsidiary mergers under section 368(a)(2)(D) and (E). The concept should be retained in modified form, however, in the "C" reorganization to ensure that the acquiring corporation acquires the target's assets in one transaction. This concept will retain the resemblance between the "A" and the "C" reorganizations and yet permit strip-down transaction before a "C" reorganization.

The ABA Tax Section has also suggested measuring whether "substantially all" the assets have been acquired by reference to the target's assets held "immediately prior to the acquisition,"<sup>132</sup> provided that the target in the "C" reorganization has not been a target in any previous "C" reorganization.<sup>133</sup> Both of these suggestions are sound and should be adopted.

*iv. Continuity of Business Enterprise and Business Purpose*

The continuity-of-business-enterprise doctrine has been the subject of a recent set of regulations<sup>134</sup> which on balance seem to be workable. Basically these regulations are designed to ensure that a constructive liquidation of the target has not taken place in the guise of a reorganization. The regulations reach this result by requiring that, in essence, the acquiring corporation continue a his-

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<sup>131</sup> *Id.* at 1399.

<sup>132</sup> *Id.* at 1400.

<sup>133</sup> *Id.*

<sup>134</sup> See Treas. Reg. § 1.368-1(d).



torical business of the target corporation.

The business-purpose requirement<sup>135</sup> is designed to ensure that the reorganization provisions are utilized only by taxpayers who have legitimate business reasons for entering the transaction.

*v. No Relative Size Limitation*

The House version of the bill that became the 1954 Code contained a relative size limitation that would have extended tax-free treatment only to mergers or acquisitions involving corporations of the same relative size.<sup>136</sup> This provision did not become law, however, and the current reorganization provision does not have a size limitation concept. Consequently, tax-free treatment is possible where, for example, a publicly traded conglomerate acquires the corner grocery store corporation. The ALI Proposals conclude that there are strong reasons for *not* adopting a relative size limitation standard,<sup>137</sup> but they set out a relative size limitation standard that might be adopted if it were decided that such a standard were appropriate.<sup>138</sup>

Basically, the rule set out in the ALI Proposals would extend nonrecognition treatment to marketable stock received in a QAA or QSA only if the target's shareholders receive, as a result of the acquisition, a proportionate common stock interest in the acquiring corporation equal to at least one-fifth of their proportionate interest in the target prior to the acquisition. Thus, if a target had one shareholder and the target were acquired in a QAA or QSA in exchange for marketable stock, in order to receive nonrecognition treatment the target's shareholder would have to receive at least twenty percent of the common stock of the acquiring corporation. Thus, this restriction would make it practically impossible for an acquiring corporation that had common stock which was worth more than five times the common stock of the target to acquire the target in a tax-free exchange in which the consideration paid was marketable stock.<sup>139</sup>

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<sup>135</sup> See, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935); Treas. Reg. § 1.368-2(g).

<sup>136</sup> ALI Proposals, *supra* note 4, at 159-63.

<sup>137</sup> *Id.* at 182-87.

<sup>138</sup> See § 359(a)(1), H.R. Rep. No. 1337, 83d Cong., 2d Sess. A133 (1954). The relative size rule that was contained in the 1954 House bill would have denied reorganization treatment to any transaction where the acquiror was more than four times larger than the target.

<sup>139</sup> The concept of limiting nonrecognition treatment where marketable stock is involved

Although strong arguments can be advanced in favor of a relative size limitation, the apparent lack of abuse in the absence of such a limitation makes it neither necessary nor appropriate to adopt such a limitation. Further, the argument made by Walter Blum against a relative size standard is compelling:

[The absence of a relative size standard] must, I submit, rest on a policy to encourage (or not impede) particular types of corporate business rearrangements. In this light it is easy to dispose of the point about the relative size of firms participating in the union. Would anyone advocate that we adopt a broad policy of encouraging the union of two equal size companies but not two firms of radically different sizes?<sup>140</sup>

The 1985 SFC Proposals extend to the absolute limit the availability of nonrecognition treatment in the acquisition of the corner grocery store corporation by the large conglomerate. For example, assume that the stock of the corner grocery store is held by two shareholders, one who owns ninety-nine percent and one who owns one percent. In the acquisition by a conglomerate in a QAA or a QSA, the one-percent shareholder will have nonrecognition treatment upon the receipt of the conglomerate's stock even though the ninety-nine-percent shareholder receives cash.<sup>141</sup>

Although a relative size limitation should not be imposed as a condition to reorganization treatment, the amount of boot that can be paid in a reorganization should be determined by reference to the relative size of the corporations.<sup>142</sup>

#### *vi. Relationship Between Section 351 and Reorganizations*

There is an interesting relationship between the absence of a relative size limitation in the reorganization provisions and section 351. In order to receive nonrecognition treatment under section 351, the transferors must be in "control" of the transferee corpora-

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was proposed in a more drastic form by Jerome R. Hellerstein, who argued that nonrecognition treatment should not be available in any reorganization transaction where the target's shareholders receive "stock traded on an exchange or in the over-the-counter market if an adequate market exists for the sale of the stock received." Hellerstein, *Mergers, Taxes, and Realism*, 71 Harv. L. Rev. 254, 284 (1957).

<sup>140</sup> Blum, *supra* note 2, at 100.

<sup>141</sup> Proposed § 354, 1985 SFC Proposals, *supra* note 6, at 83.

<sup>142</sup> See *infra* notes 179-81 and accompanying text.

tion. Control in essence means the ownership of eighty percent of the transferee's voting and nonvoting stock.<sup>143</sup> For example, if the owner of a corner grocery store that is operated as a sole proprietorship transfers the business to a conglomerate in exchange for stock, the transaction is clearly taxable. On the other hand, if the corner store happened to be operated as a corporation, the transfer of the stock or assets in exchange for the conglomerate's stock could clearly qualify as a tax-free reorganization. Thus, we see that the reorganization provisions, at least to an extent, are inconsistent with section 351. If the sole proprietor were to incorporate his grocery store for the purpose of immediately entering into a reorganization transaction, the Service would take the position that the incorporation and subsequent acquisition transaction should be treated as a mere sale.<sup>144</sup>

The 1985 SFC Proposals amend section 351 to allow such transfers prior to a QAA or QSA where the transferor is a corporation and the assets transferred are "sufficient for the active conduct of a trade or business (within the meaning of section 355(b)(2)), but without regard to the 5-year requirement by the transferee."<sup>145</sup> This provision is sound because it eliminates the need for a corporation to operate its various businesses through subsidiaries in order to qualify a disposition of one of those businesses as a QAA or QSA. The rules should go a long way toward addressing one of Professor Ginsburg's criticisms of the 1983 SFC Original Proposals.<sup>146</sup>

The same reasoning that supports this type of provision for a corporate transferor (*i.e.*, no need to artificially limit the form of business organization) also applies in the case of a sole proprietorship or a partnership. Therefore, section 351 should be available for transfers to a corporation by proprietors or partners of the assets and liabilities of an actively conducted trade or business, where the corporation is subsequently acquired in a tax-free reorganization.

While the reorganization provisions can be viewed as undermin-

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<sup>143</sup> I.R.C. § 368(c)(1).

<sup>144</sup> See, *e.g.*, Rev. Rul. 70-140, 1970-1 C.B. 73. The Service would likely prevail in this position. See, *e.g.*, *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966).

<sup>145</sup> Proposed § 351(e)(1)(B), 1985 SFC Proposals, *supra* note 6, at 81.

<sup>146</sup> See Ginsburg, *Special Topics in the Acquisition Area*, 22 San Diego L. Rev. 159 (1985).

ing the purposes of section 351 by extending nonrecognition treatment to certain corporation acquisitions that would not be given such treatment if the transaction were structured as a contribution of property to a corporation, the reverse is also true. That is, section 351 may be used to give nonrecognition treatment to shareholders of a target corporation in an acquisition transaction that does not qualify as a reorganization under current law. For example, the acquiring corporation and a minority shareholder of the target (e.g., a fifteen-percent shareholder) can form a new corporation with the acquiring corporation contributing cash and the minority shareholder contributing target stock. The acquiring corporation might receive all of the common stock of the new corporation and the minority shareholder all of the preferred. The transaction on its face qualifies under section 351 and the minority shareholder receives nonrecognition treatment. The new corporation then purchases for cash the eighty-five percent balance of the stock of the target. As a result, the acquiring corporation has acquired all of the common equity in the target for eighty-five percent cash and fifteen-percent stock, the minority shareholder has received nonrecognition treatment, and the majority shareholders have a taxable transaction. Further, the new corporation could make a section 338 election and step up the basis of the target's assets.

The Service has been around in a circle on this type of transaction, first ruling in the *National Starch* private letter ruling that it qualifies under section 351,<sup>147</sup> then issuing two revenue rulings denying section 351 treatment,<sup>148</sup> and, finally, withdrawing its two published rulings and holding, in another revenue ruling, that section 351 applies.<sup>149</sup> The 1985 SFC Proposals would return to the Service's original position and deny section 351 treatment to any transaction that qualifies as a QAA or QSA, except as provided in regulations.<sup>150</sup>

#### b. Comments on the Proposed QAA and QSA

The definition of a QSA and QAA is straightforward and cer-

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<sup>147</sup> See Pvt. Ltr. Rul. 7839060 (June 28, 1978).

<sup>148</sup> See Rev. Rul. 80-284, 1980-2 C.B. 117; Rev. Rul. 80-285, 1980-2 C.B. 119.

<sup>149</sup> Rev. Rul. 84-71, 1984-1 C.B. 106.

<sup>150</sup> Proposed § 351(d)(1), 1985 SFC Proposals, *supra* note 6, at 80.

tainly eliminates the disparities in the present boot, continuity-of-interest, and "substantially all" rules. The 1985 SFC Proposals, however, proceed too far in abolishing the continuity-of-interest, continuity-of-business-enterprise, and business-purpose doctrines.

For example, by repealing the continuity-of-business-enterprise and continuity-of-interest doctrines, the 1985 SFC Proposals would allow tax-free treatment on the constructive liquidation of a corporation. This could happen where a target corporation sold all of its assets and thereafter held only cash. An acquiring corporation could then cause the target to merge into the acquiror with the target's shareholders receiving stock of the acquiring corporation in exchange for their target stock. The merger transaction would qualify as a QAA; therefore, the shareholders of the target would receive nonrecognition treatment on receipt of the stock of the acquiring corporation. Obviously this transaction is a mere liquidation of the target and yet the target's shareholders receive nonrecognition treatment.

The situation could be even worse. After the asset sale, the target could, for example, distribute cash to eighty percent or ninety percent of its shareholders in redemption of their stock and then merge into the acquiring corporation with the remaining target shareholders receiving stock of the acquiring corporation. Because of the repeal of the *Elkhorn Coal* case and the consequent disregard of the distribution in determining whether the 90-70 test has been satisfied, the merger would qualify as a QAA and the remaining target shareholders would receive nonrecognition treatment.<sup>151</sup> Here there is a liquidation to the extent of eighty to ninety percent of the target's shareholders, followed by the acquisition of the minority's share of the cash in a tax-free transaction.<sup>152</sup>

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

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<sup>151</sup> See *supra* notes 81.1-.2 and accompanying text. This assumes that the constructive receipt doctrine would not apply to treat the remaining target shareholders as having received cash.

<sup>152</sup> Under the 1985 SFC Proposals, tax-free treatment would not be available in this transaction if the acquiring corporation were an investment company. See Proposed § 354(d)(1), 1985 SFC Proposals, *supra* note 6, at 84-85.

business-enterprise, and business-purpose doctrines.

Another problem is the unlimited boot feature of the 1985 SFC Proposals. This provision is hard to justify in a tax system that has always provided, as a general rule, that taxpayers are subject to taxation on an exchange of property. The reorganization provisions, which provide an exception to the general taxation rule, were first added in the Revenue Act of 1918.<sup>153</sup> In interpreting this and successor provisions, courts have uniformly held that a reorganization contemplates a continuing interest by the target's shareholders in the "affairs" of the acquiring corporation through a stock ownership interest in the acquiring corporation.<sup>154</sup> In enacting the "solely for voting stock" requirement of section 368(a)(1)(B), (C), and 368(a)(2)(E) reorganizations, Congress has codified this continuing interest requirement. Furthermore, the regulations and case law make it clear that there must be some continuation of the target's business by the acquiring corporation.<sup>155</sup>

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

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

Admittedly, there are aberrations with the continuity-of-interest

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<sup>153</sup> Pub. L. No. 65-254, § 202, 40 Stat. 1057, 1060.

<sup>154</sup> See, e.g., *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935).

<sup>155</sup> See Treas. Reg. § 1.368-1(d).

doctrine. For example, as noted above, there is no relative size element in the doctrine so that a large acquiring corporation can acquire a small target and yet have the transaction qualify as a reorganization. Additionally, nonvoting preferred stock qualifies under present law for continuity-of-interest purposes.<sup>156</sup> However, as discussed below, most of these defects in the concept can be corrected.

One reason that is often given as a justification for abolishing the continuity-of-interest doctrine and adopting the approach of the 1985 SFC Proposals is that taxpayers, like Mrs. Kass,<sup>157</sup> can inadvertently get caught in their failure to satisfy the requirement and, as a result, be taxed on the receipt of stock of an acquiring corporation.<sup>158</sup> However, often the taxpayer who inadvertently fails to meet the continuity-of-interest requirement is not one who is unfairly deprived of nonrecognition treatment.<sup>159</sup>

Certainly, the current reorganization provisions are complex, but the 1985 SFC Proposals are not themselves a model of simplicity. It would be a serious mistake to assume that mergers and acquisi-

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<sup>156</sup> See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

<sup>157</sup> *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (per curiam).

<sup>158</sup> See, e.g., *Wolfman*, *supra* note 4.

<sup>159</sup> Mrs. Kass is a good example. She was a minority shareholder of a target corporation. 60 T.C. at 219. Shareholders of the target corporation owning approximately 10% of the target stock transferred that stock to a new corporation (acquiring corporation). See *id.* at 220. The acquiring corporation then purchased, pursuant to a tender offer, approximately 83% of the target's stock. See *id.* After the purchase, the target was then merged upstream into the acquiring corporation in a transaction that was treated as a § 334(b)(2) liquidation thereby stepping up the basis of the target's assets. See *id.* at 220-21. Mrs. Kass received stock of the acquiring corporation and sought nonrecognition treatment on the transaction. See *id.* The Tax Court held that the purchase by the acquiring corporation of the target's stock and the subsequent upstream merger were all part of one transaction that failed to satisfy the continuity-of-interest requirement for reorganization treatment. See *id.* at 225-27.

This is not a shocking result, and it is the correct tax policy result. First, the transaction was one in which 83% of the target's shareholders were cashed out, and the bases in the target's assets were stepped up. Second, Mrs. Kass did not have to take stock in the merger. She could have sold her stock for cash in the tender offer, or she could have dissented from the merger and have been paid the appraised value of her shares. Third, if instead of an upstream merger there had been a mere liquidation of the target under corporation law with Mrs. Kass receiving stock of the acquiring corporation, there would have been no question that the transaction would have been taxable to her. Finally, the transaction was not a mere continuation of the business by the same owners, but rather was a sale transaction that should be taxed as such.

tions will be simple if the Proposals are enacted.<sup>160</sup> Although the Proposals *somewhat* simplify the mergers and acquisitions provisions, their relaxation of abuse safeguards simply does not justify their wholesale adoption as a conceptual substitute for the present reorganization provisions.

Finally, recall that the 1985 SFC Proposals contain a reverse acquisition provision, the purpose of which is to prevent the disguising of the real acquiring corporation as a target with respect to which a QSA or QAA has taken place.<sup>161</sup> Under this provision, if the shareholders of a nominal target end up with more than fifty percent of the stock of the nominal acquiring corporation, then the nominal target is treated as the real acquiring corporation and the nominal acquiring corporation is treated as the real target. There is no reverse acquisition provision in the current reorganization provisions and, consequently, it is possible to avoid the continuity-of-interest requirement by, for example, having a large corporation which is really the acquiring corporation merge into the target with, *e.g.*, eighty percent of the target's shareholders receiving cash in redemption of their stock and the remaining twenty percent keeping their stock. This transaction would, under current law, be a good reorganization notwithstanding the fact that it undermines the continuity-of-interest requirement. As indicated below, a reverse acquisition provision similar to the one proposed in the 1985 SFC Proposals should be added to the present reorganization provision.<sup>162</sup>

## 2. A Suggested Alternative Approach

### a. In General

The case has not been made for repeal of the reorganization concept. Consequently, the concept of the QAA and QSA should be rejected, and the reorganization definition should be revised to set forth uniform and consistent requirements<sup>163</sup> for the various forms of acquisitive reorganizations, in many respects along the lines of

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<sup>160</sup> See *supra* note 63 and accompanying text.

<sup>161</sup> See *supra* notes 92-96 and accompanying text.

<sup>162</sup> See *infra* notes 177-78 and accompanying text.

<sup>163</sup> See also Faber, *Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows?*, 34 Tax Law. 239 (1981) (suggesting, *inter alia*, a uniform consideration); Jacobs, *Reorganizing the Reorganization Provisions*, 35 Tax L. Rev. 415 (1980).



the ABA Reorganization Recommendations with the incorporation of some of the principles of the 1985 SFC Proposals. Specifically, the following approach should be adopted.

The continuity-of-interest test should be strengthened and clarified in several respects, including adoption of clear rules for the treatment of pre- and post-reorganization transactions and adoption of a reverse acquisition rule. These points are developed in part b. below. The amount of boot that can be used in a reorganization should be a function of the relative size of the target and acquiring corporations, as discussed in part c. below.

The continuity-of-business-enterprise and business-purpose tests should be retained. The essential elements of the present regulations dealing with continuity-of-business-enterprise should be codified.<sup>164</sup>

The "substantially all" test should be retained for the "C" reorganization, but it should be measured only with respect to assets of the target held immediately before the reorganization, as provided in the ABA Reorganization Recommendations.<sup>165</sup>

The *Bausch & Lomb*<sup>166</sup> principle should be reversed as suggested by the ABA Reorganization Recommendations.<sup>167</sup> That case held that where the acquiring corporation holds stock of the target and acquires the target's assets for voting stock in a purported "C" reorganization, the surrender of the target's stock by the acquiring corporation in liquidation of the target constitutes boot paid by the acquiring corporation.

Finally, as indicated above, the provision in the 1985 SFC Proposals that would allow a corporation to transfer a trade or business to a subsidiary corporation in a transaction that qualifies for nonrecognition treatment under section 351 even though the subsidiary is subsequently acquired in a QAA or QSA should be adopted. This treatment should also be extended to sole proprietors and partners in order not to penalize taxpayers who operate in such forms. However, it should be made clear that this provision is available only if the assets and liabilities of an actively conducted trade or business are transferred to the newly formed corporation.

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<sup>164</sup> See Treas. Reg. § 1.368-1(d).

<sup>165</sup> See *supra* notes 131-33 and accompanying text.

<sup>166</sup> *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959).

<sup>167</sup> ABA Reorganization Recommendations, *supra* note 2, at 1398.

This would protect section 351 from attempts to incorporate passive assets.

With these changes, many of the aberrational effects in the reorganization provisions would be eliminated and there would be a more logical and consistent scheme for taxing reorganizations.

*b. The Continuity-of-Interest Requirement*

As previously discussed, the continuity-of-interest requirement under current law places different restrictions on the types of stock that may be received dependent on the form of the acquisitive reorganization.<sup>168</sup> For each of these acquisitive reorganizations there should be a requirement that a minimum amount of consideration be voting common stock of the acquiring corporation, or of the common parent of the group of which the acquiring corporation is a member, or of such other corporation as may be specified in regulations. The minimum amount should be determined by reference to the amount of permissible boot, which is discussed in part c. below. For example, if the permissible boot is thirty percent, then seventy percent of the consideration would have to constitute voting common stock of the acquiring corporation. As long as this basic continuity-of-interest requirement is satisfied, any other stock of the acquiring corporation (or of its common parent or any other corporation specified in regulations), whether common or preferred, voting or nonvoting, would qualify for nonrecognition treatment. However, this rule should be subject to the exception that nonvoting common or voting and nonvoting preferred stock of the acquiring corporation could be issued in exchange for similar stock of the target as long as the target's capital structure was not shifted from voting common to nonvoting common or to preferred for the purpose of avoiding the basic continuity-of-interest rule.

Requiring a minimum amount of voting common stock ensures that the transaction represents a continuation by the target's shareholders of an equity interest in the combined venture. While financial accounting rules certainly do not govern for tax purposes, it is instructive to note that in order to account for an acquisition as a pooling rather than a purchase for financial accounting purposes, the acquiring corporation must issue "only common stock

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<sup>168</sup> See *supra* text accompanying note 112.

with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all (*i.e.*, ninety percent) of the voting common stock interest of the [target]."<sup>169</sup> It is obvious that this accounting rule was adopted with a view to setting a very high threshold for pooling-of-interest treatment, and it is likewise appropriate to set a very high standard for tax-free treatment. It bears emphasis, however, that the author does not suggest here that the accounting "substantially all" test, which in essence allows only ten percent boot, be adopted. Since the voting common stock issued can be that of either the acquiring corporation, its common parent, or any other corporation specified in regulations, the *Groman* and *Bashford* doctrines would be overridden.<sup>170</sup>

Pre-reorganization sales by the target's shareholders should be disregarded, except for sales within two years before the reorganization to, or arranged by, the acquiring corporation or any corporation or person controlled by, or in direct or indirect control of, the acquiring corporation. Any such sales to the acquiring corporation or a related entity would be considered boot in the transaction. This is essentially the rule recommended in the ABA Reorganization Recommendations,<sup>171</sup> and would codify the Service's position in Revenue Ruling 85-138.<sup>172</sup> This rule obviously eliminates the issue of whether the continuity-of-interest requirement is satisfied where arbitrageurs buy a substantial portion of the target's stock in contemplation of the reorganization.

Post-reorganization sales would not be considered for continuity-of-interest purposes as long as they were not "pursuant to an arrangement negotiated or agreed upon prior to the [reorganization]."<sup>173</sup> This is the standard used in the current regulations for determining whether a spin-off is a device for the distribution of earnings and profits under section 355(a)(1)(B), and it seems to be an appropriate standard here.<sup>174</sup> This approach would, in essence,

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<sup>169</sup> Accounting Principles Board Opinion No. 16 ¶ 47b.

<sup>170</sup> See *supra* note 48 and accompanying text. This rule is similar to the "party to the acquisition" rule set forth in the 1985 SFC Proposals. Proposed § 366(d), 1985 SFC Proposals, *supra* note 6, at 130.

<sup>171</sup> ABA Reorganization Recommendations, *supra* note 2, at 1395.

<sup>172</sup> 1985-36 I.R.B. 5.

<sup>173</sup> Treas. Reg. § 1.355-2(b)(1).

<sup>174</sup> Any purchases or redemptions within two years after the reorganization, of stock is-

codify the Seventh Circuit's holding in *McDonald's*<sup>176</sup> and the Service's position in Revenue Ruling 85-139.<sup>176</sup>

The continuity-of-interest test should also be strengthened by adopting a reverse acquisition rule along the lines set forth in the 1985 SFC Proposals.<sup>177</sup> Indeed, it is essential to the integrity of the continuity-of-interest doctrine that the reverse acquisition concept be adopted.<sup>178</sup>

### c. Determination of the Amount of Permissible Boot

Although there are competing considerations, for the reasons previously discussed there should not be a relative size standard for reorganizations.<sup>179</sup> Nevertheless, if the tax system is to allow a large conglomerate to acquire the corner grocery store in a tax-free reorganization, at the very least the system should require that a substantial amount of the conglomerate's stock pass in the transaction. In measuring the substantiality of the stock consideration given in such transactions, the proportion of the consideration that consists of voting common stock should increase as the size of the target becomes smaller in relation to the acquiring corporation. It would seem that an appropriate standard would be as follows:

	<u>Relative Size of Target to Acquiror</u>	<u>Permissible Boot</u>
Less than	1 to 20	10%
Less than	1 to 10	20%
Less than	1 to 5	30%
More than	1 to 5	40%

Thus, the maximum permissible boot in a reorganization where a conglomerate acquires the corner grocery store would be ten percent, while the maximum boot where the acquiror is no more than five times as large as the target would be forty percent. This

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sued in a reorganization that are made or arranged by the acquiring corporation should be presumed to be "pursuant to an arrangement."

<sup>176</sup> *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

<sup>176</sup> 1985-36 I.R.B. 6.

<sup>177</sup> See Proposed § 366(e), 1985 SFC Proposals, *supra* note 6, at 131.

<sup>178</sup> See Turnier, *Continuity of Interest — Its Application to Shareholders of the Acquiring Corporation*, 64 Calif. L. Rev. 902 (1976).

<sup>179</sup> See *supra* notes 136-42 and accompanying text. Perhaps if we were writing on a completely clean slate, we would write such a rule.

amount of allowable boot should be sufficient to take care of dissenters and other shareholders who desire to be cashed out.<sup>180</sup>

The guiding principle behind this boot standard is that in order to receive the benefit of tax-free reorganization treatment, the transaction should result in the target's shareholders receiving a significant stock interest in the acquiring corporation as measured by their stock interest in the target, and the smaller the target relative to the acquirer the greater the amount of required stock consideration. This standard should not add undue complexity to the reorganization definition and would be uniform for all forms of reorganization.

The size of the target and the acquirer would be determined by the relative fair market values of the outstanding voting common stock of both the target and the acquiring corporations. The boot limitation could be determined simply by referring to the percentage of the voting stock of the acquiring corporation that is held by the target's shareholders as a result of the reorganization. If the target's shareholders hold, as a result of the reorganization, more than twenty percent of the acquiring corporation's voting common stock, then forty percent of the consideration paid for all of the stock of the target (whether voting or nonvoting common or preferred) could be boot (*i.e.*, nonstock consideration).

In determining whether the boot limitation is exceeded in contingent payment transactions, any stock of the acquiring corporation that could be issued pursuant to a contingent payment would be ignored and any boot that could be issued would be treated as if it were issued at the time of the reorganization. Otherwise, the Service's guidelines for reorganizations involving contingent payments should not be changed.<sup>181</sup>

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<sup>180</sup> In this regard it should be noted that in 1958 the American Law Institute suggested that the maximum amount of boot be 33 $\frac{1}{3}$ % of the consideration paid for the target and that only fully participating stock qualify in determining whether the suggested 66 $\frac{2}{3}$ % continuity-of-interest test was satisfied. See 1958 ALI Report, *supra* note 2, at 326. Also, Walter Blum has suggested that the maximum amount of boot in a reorganization be 20%. Blum, *supra* note 2, at 89-90.

<sup>181</sup> See Rev. Proc. 84-42, § 3.03, 1984-1 C.B. 521. For a similar approach to contingent payouts, see Blum, *supra* note 2, at 93.

IV. 1985 SFC PROPOSED AND SUGGESTED ALTERNATIVE  
TREATMENT OF TAXPAYERS INVOLVED IN ACQUISITIVE CORPORATE  
TRANSACTIONS

A. 1985 SFC Proposed Tax Treatment of Target's Shareholders  
and Securityholders

1. General Nonrecognition Rule Under 1985 SFC Proposals

Under the 1985 SFC Proposals, a target's shareholders in a QSA or a QAA would receive nonrecognition treatment to the extent stock or securities of a corporation which is a "party to the acquisition" are exchanged solely for stock or securities of the target.<sup>182</sup> This essentially retains the rule embodied in current section 354(a), except that there is no "plan of reorganization" requirement. Also, since there is no continuity-of-interest requirement for a QSA or a QAA, a transaction such as that in *Kass*,<sup>183</sup> where most target shareholders receive cash and only a small percentage of the shareholders (five percent in *Kass*) receive stock of the acquiring corporation, will give rise to nonrecognition treatment to any target shareholders who receive stock.

Since the term "party to the acquisition" includes the acquiring corporation and, where the acquiring corporation is a member of an affiliated group, the common parent and any other member specified in regulations,<sup>184</sup> the target shareholders can receive nonrecognition treatment upon receiving stock of any of these corporations. In contrast, the definition of "reorganization" under current law permits nonrecognition treatment for the receipt of stock of only the acquiring corporation or its direct parent.<sup>185</sup>

For purposes of determining nonrecognition treatment, the term QSA includes the acquisition of the stock of a target where immediately after the acquisition the acquiring corporation has control of the target, whether or not the acquiring corporation had control immediately before the acquisition.<sup>186</sup> This is a codification of the current regulations under section 368(a)(1)(B), which afford tax-

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<sup>182</sup> Proposed § 354(a), 1985 SFC Proposals, *supra* note 6, at 83.

<sup>183</sup> See *supra* note 159.

<sup>184</sup> Proposed § 366(d), 1985 SFC Proposals, *supra* note 6, at 130.

<sup>185</sup> See I.R.C. § 368(b).

<sup>186</sup> Proposed § 354(b), 1985 SFC Proposals, *supra* note 6, at 84.

free treatment to the so-called "creeping (B)" reorganization.<sup>187</sup>

If the acquiring corporation is a member of an affiliated group, the 1985 SFC Proposals provide that the acquiring corporation is treated as holding stock of the target held by other members of the group.<sup>188</sup> The effect of this provision is to give the target's shareholders the benefit of nonrecognition treatment in such a transaction, even though the transaction does not qualify as a QSA for purposes of the target's cost-basis election, discussed below. If the transaction is not a QSA for purposes of the Cost Election, the target's assets will automatically retain their basis.

## 2. Exchange of Securities Under 1985 SFC Proposals

The 1985 SFC Proposals contain a limitation on the excess principal amount of securities received in a QSA or QAA similar to that contained under current law<sup>189</sup> for the excess principal amount of securities received in a reorganization.<sup>190</sup> The nonrecognition rule does not apply to the extent that the issue price of any securities of a party to the acquisition received exceeds the adjusted basis of any securities of the target surrendered.<sup>191</sup> The excess of the issue price of the securities received over the adjusted basis of the securities surrendered is treated as "nonqualifying consideration" and as such is treated as boot.<sup>192</sup> Thus, as will be seen in the discussion of boot below, an excess principal amount of securities received is treated as nonqualifying consideration and

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<sup>187</sup> See Treas. Reg. § 1.368-2(c).

<sup>188</sup> Proposed § 354(b), 1985 SFC Proposals, *supra* note 6, at 84.

<sup>189</sup> Section 354(a)(2)(A) limits the nonrecognition treatment for securityholders to cases in which the principal amount of securities received is not greater than the principal amount surrendered. In the event cash or other property (boot) is received, or the principal amount of the securities received exceeds the principal amount of the securities surrendered, then under § 356 the exchanging securityholder recognizes gain to the extent of the boot and the fair market value of the excess principal amount of the securities received. See I.R.C. § 356(a)(1), (d)(2)(A), (B).

<sup>190</sup> Proposed §§ 354(d)(2), 356(a), 366(f)(2), 1985 SFC Proposals, *supra* note 6, at 85, 94, 131-32.

<sup>191</sup> Proposed § 354(d)(2), *id.* at 85. However, under both current § 354(a)(2)(B) and the Proposals, Proposed § 354(d)(3), *id.* at 85-86, if pursuant to a reorganization a securityholder receives stock, securities, or other property in respect of interest which has accrued on such securities during the period such securityholder held the securities, then the amounts so received are treated as interest income; this principle applies whether or not the securityholder recognizes gain on the transaction.

<sup>192</sup> Proposed § 366(f)(2)(B), *id.* at 131-32.

triggers gain recognition.<sup>193</sup>

### 3. Treatment of Boot Under 1985 SFC Proposals

#### a. General Rule

The 1985 SFC Proposals contain essentially the same boot gain rule that is contained in current section 356(a)(1).<sup>194</sup> Proposed section 356(a) provides:

Except as provided in this section, if section 354 or 355 would apply to an exchange but for the fact that any shareholder or security holder receives nonqualifying consideration, then such shareholder or security holder shall recognize gain (if any), but in an amount not in excess of the fair market value of the nonqualifying consideration.<sup>195</sup>

In order to understand the term "nonqualifying consideration," it is necessary to refer first to the term "qualifying consideration," defined as "property" which is received in an exchange without recognition of gain by reason of section 351, 354, 355, 356, or 361, whichever is appropriate.<sup>196</sup> Thus, in the case of a QA, qualifying consideration is stock or securities of a "party to the acquisition" that is received by the shareholders or securityholders of the target corporation in a nonrecognition transaction under Proposed section 354.<sup>197</sup>

"Nonqualifying consideration" is defined as "property (including money) received in an exchange to which section 351, 354, 356 or 361 applies, whichever is appropriate, other than qualifying consideration."<sup>198</sup> In a situation where securities are received in such an exchange, nonqualifying consideration includes "the excess of the issue price of such securities over the adjusted basis of any securities surrendered in such exchange."<sup>199</sup> This limitation is similar to the excess principal amount provision of current section 356(d), ex-

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<sup>193</sup> Proposed § 356(a), *id.* at 94.

<sup>194</sup> Under current § 356(a)(1), a target's shareholder recognizes gain to the extent of the "boot" received (*i.e.*, money and fair market value of other property received). I.R.C. § 356(a)(1).

<sup>195</sup> Proposed § 356(a), 1985 SFC Proposals, *supra* note 6, at 94.

<sup>196</sup> Proposed § 366(f)(1), *id.*

<sup>197</sup> See the discussion of Proposed § 354, *supra* text accompanying notes 182-88.

<sup>198</sup> Proposed § 366(f)(2)(A), 1985 SFC Proposals, *supra* note 6, at 131.

<sup>199</sup> Proposed § 366(f)(2)(B), *id.* at 131-32.



cept that the determination of whether there is an excess amount of securities received is made by comparing the issue price of the securities received with the adjusted basis of the securities surrendered.

As under current law,<sup>200</sup> no loss is recognized if the exchange is within Proposed section 356(a).<sup>201</sup> However, if a shareholder or securityholder of the target corporation does not receive in the exchange stock of a party to the acquisition, or a securityholder of the target does not receive stock or securities of a party to the acquisition, then such person recognizes loss (if any) on the exchange. This latter point seems to be a mere clarification of current law.

### *b. Amount of Dividend*

The 1985 SFC Proposals eliminate the gain limitation on the amount of boot that can be treated as a dividend under current section 356(a)(2).<sup>202</sup> Also, the 1985 SFC Proposals essentially codify the Service's view of the method of determining the amount of a dividend.

Under current law, the Service has been contending that it is proper to look at the earnings and profits of both the target and the acquiring corporations under section 356(a)(2). The Tax Court's position is that only the target's earnings and profits are to be considered in determining the amount of earnings and profits for purposes of section 356(a)(2).<sup>203</sup> The Fifth Circuit has held that in a nondivisive section 368(a)(1)(D) reorganization the earnings and profits of both the distributing and the controlled corporations are counted for purposes of section 356(a)(2).<sup>204</sup>

Under the 1985 SFC Proposals, if an exchange has the effect of a dividend, then the recipient of the boot is treated as having received a dividend equal to the lesser of (1) the fair market value of

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<sup>200</sup> See I.R.C. § 356(c).

<sup>201</sup> Proposed § 356(c)(1), 1985 SFC Proposals, *supra* note 6, at 94.

<sup>202</sup> Under current § 356(a)(2), any gain recognized may be treated as a dividend to the extent of the shareholder's pro rata share of the accumulated earnings and profits, if the exchange has the "effect of . . . a dividend."

<sup>203</sup> See *Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978) ("D" reorganization); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970) (same).

<sup>204</sup> See *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

the nonqualifying consideration received, or (2) his ratable share of the undistributed accumulated E&P of the target and any other party to the acquisition the stock or securities of which are received by the shareholder.<sup>205</sup> If the amount of the gain recognized exceeds the amount that is treated as a dividend, then the excess is treated as gain from the sale or exchange of property.<sup>206</sup>

*c. Determining Whether a Distribution Has the Effect of a Dividend*

The 1985 SFC Proposals provide that for purposes of determining whether a distribution has the effect of a distribution of a dividend in a QSA or QAA, the target's shareholders are treated as having transferred the target's stock in exchange for stock of the acquiring corporation or other party to the acquisition.<sup>207</sup> Thereafter, the shareholders are treated as having received on the acquisition date the nonqualifying consideration in a redemption by the acquiring corporation of its stock, in a transaction that is governed by current section 302.<sup>208</sup> Thus, the Proposals would codify the principle set out in *Wright v. United States*,<sup>209</sup> where the Eighth Circuit held that in determining whether a boot distribution in an acquisitive reorganization has the effect of the distribution of a dividend within the meaning of section 356(a)(2), the distribution is considered as if made by the acquiring corporation. Thus, the target's shareholders are treated as if (1) the only consideration they receive is stock of the acquiror, and (2) immediately thereafter the acquiror redeems a portion of their stock with the boot. Where the acquiror is large relative to the target, the distribution is likely to qualify as a current section 302(a) redemption.

Proposed section 356(d)(3) is contrary to the current position of the Service, who in Revenue Ruling 75-83<sup>210</sup> announced that it would not follow *Wright* and that "it will continue to view" boot distributions as having been made by the target corporation.<sup>211</sup>

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<sup>205</sup> Proposed § 356(d)(1), 1985 SFC Proposals, *supra* note 6, at 95-96.

<sup>206</sup> Proposed § 356(d)(2), *id.* at 96.

<sup>207</sup> Proposed § 356(d)(3), *id.* at 97.

<sup>208</sup> *Id.*

<sup>209</sup> 482 F.2d 600 (8th Cir. 1973).

<sup>210</sup> 1975-1 C.B. 112.

<sup>211</sup> Similarly, in *Shimberg v. United States*, 577 F.2d 203 (5th Cir. 1978), the Fifth Circuit held that a pro rata distribution of boot to the target's shareholders gave rise to dividend

*d. Dispositions of Subsidiaries*

There is a special provision in the 1985 SFC Proposals governing situations where a "controlling corporate shareholder," defined as a corporation that owns "stock representing control of another corporation"<sup>212</sup> (*i.e.*, a parent), receives nonqualifying consideration upon the disposition of a target (*i.e.*, a subsidiary) in a QA.<sup>213</sup>

First, section 332 does not apply to such transactions that are QAAs of the subsidiary.<sup>214</sup> Second, even if a loss otherwise would be recognized because the parent does not receive qualifying consideration,<sup>215</sup> no loss is recognized.<sup>216</sup> Third, even though gain otherwise would be recognized upon the receipt of nonqualifying consideration,<sup>217</sup> no gain is recognized by the parent if the QA is either a:

- (1) *Cost Basis Acquisition, i.e.*, an acquisition where the target recognizes gain and has the basis of its assets stepped up, as defined below, or
- (2) *Carryover Basis Acquisition, i.e.*, an acquisition where the target does not recognize gain and the acquirer takes the target's old basis for its assets, as defined below, and the parent "distributes all of its assets (other than assets necessary to meet preexisting claims) to its shareholders and creditors within 12 months of

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treatment under current § 356(a)(2). The taxpayer-shareholder controlled 68% of the target but only 1% of the acquirer. The court said:

[W]e decline to apply on a wholesale basis the "meaningful reduction" test in cases arising under § 356(a)(2) . . . . A contrary holding would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations.

If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate forms," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2).

*Id.* at 287-88.

<sup>212</sup> Proposed § 366(g), 1985 SFC Proposals, *supra* note 6, at 132.

<sup>213</sup> Proposed § 356(e), *id.* at 98.

<sup>214</sup> Proposed § 356(e)(1)(A), *id.*

<sup>215</sup> Proposed § 356(c)(2), *id.* at 94-95.

<sup>216</sup> Proposed § 356(e)(1)(B), *id.* at 98.

<sup>217</sup> Proposed § 356(a), *id.* at 94.

the acquisition date.<sup>218</sup>

The purpose of the exception for *Cost Basis Acquisitions* of a subsidiary is to prevent a parent corporation from incurring a double tax on the transaction. Since the subsidiary (*i.e.*, target) will be subject to taxation on the transaction, if the parent were also subject to taxation on the receipt of nonqualifying consideration there would be two taxes on the same gain, whereas if the parent had operated the subsidiary as a division and had merely sold the assets in a transaction that was not a QA there would have been only one tax.

The purpose of the exception for *Carryover Basis Acquisitions* of a subsidiary where the parent is liquidated within twelve months is to prevent the parent from having a taxable gain on the transaction without a concomitant step-up in the basis of the subsidiary's assets in the hands of the acquiring corporation. Since the parent is required to liquidate, there will be a shareholder-level tax on receipt of nonqualifying consideration.<sup>219</sup>

#### 4. *Substituted Basis for Target's Shareholders Under 1985 SFC Proposals*

The 1985 SFC Proposals contain a substituted-basis provision<sup>220</sup> that is essentially the same as current section 358<sup>221</sup> for standard QAs. In the case where a controlling corporate shareholder (parent) receives qualifying consideration upon the disposition of a subsidiary in a QA, the basis of such qualifying consideration is equal to the lesser of (1) the basis of the stock or securities of the subsidiary for which the consideration was received, or (2) the fair market value of such qualifying consideration.<sup>222</sup> This rule also applies in recapitalizations and changes in identity.<sup>223</sup> In a case where

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<sup>218</sup> Proposed § 356(e)(1)(C), *id.* at 98. Except as provided in regulations, § 332 will not apply to this type of distribution.

<sup>219</sup> See also Proposed § 356(e)(2), *id.* at 98-99 (special rule involving stock of subsidiary acquired in an asset acquisition of the target).

<sup>220</sup> Proposed § 358, *id.* at 102-06.

<sup>221</sup> Under current § 358, the exchanging securityholder who receives nonrecognition treatment under § 354 or partial nonrecognition treatment under § 356 takes the stock or securities received at a substituted basis, decreased by the amount of any boot received and increased by any gain recognized.

<sup>222</sup> Proposed § 358(c)(1), 1985 SFC Proposals, *supra* note 6, at 104.

<sup>223</sup> Proposed § 358(c)(3), *id.* at 105.

a parent disposes of a subsidiary in a *Cost Basis Acquisition* or in a *Carryover Basis Acquisition* followed by liquidation of the parent, the basis of any qualifying consideration is the fair market value of such consideration.<sup>224</sup>

### 5. Example of Treatment of Target's Shareholders Under 1985 SFC Proposals

The treatment of the target's shareholders under the 1985 SFC Proposals is essentially the same as the treatment under current law with two principal exceptions. First, there is certainty in the determination of whether the transaction has the effect of a dividend. Second, the target shareholders have nonrecognition treatment for stock of the acquiring corporation (or certain affiliates) received without respect to the aggregate amount of such stock received by the target's shareholders (*i.e.*, *Kass* is overruled).

For example, assume that individual "S" owns all the stock of a target corporation ("TC"). The stock has a value of \$1000, and S's basis is \$100. TC merges into acquiring corporation ("AC") in a transaction that qualifies as a QAA (a current "A" reorganization). If S receives, in exchange for his target stock, \$800 of cash and \$200 of AC stock, S would have a taxable gain (and possibly a dividend) of \$800 and nonrecognition of \$100.<sup>225</sup> The basis for his AC stock would be \$100, equal to the starting basis for his target stock (\$100) less the nonqualifying consideration received (\$800), plus the gain recognized (\$800).<sup>226</sup>

### 6. Shareholder Basis Adjustment

As discussed below in Section V.A.2.b., in the case of certain small target corporations, the target's shareholders would be given a basis increase in their stock to reflect the after-tax proceeds with respect to the corporate-level tax on certain long-held capital assets.<sup>227</sup>

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<sup>224</sup> Proposed § 358(c)(2), *id.* at 104-05.

<sup>225</sup> Proposed § 356(a), *id.* at 94.

<sup>226</sup> Proposed § 358, *id.* at 102-06.

<sup>227</sup> The Proposals also contain special rules applicable to investment companies. See generally Proposed § 354(d)(1)(A), (B), (e)(1)-(4), *id.* at 84-88.

*B. Suggested Approach to the Tax Treatment of the Target's Shareholders and Securityholders*

As noted, the 1985 SFC Proposals retain most of the features of current law governing the tax treatment of the target's shareholders and securityholders. The principal change set forth in the 1985 SFC Proposals relates to the codification of the *Wright* case for determining whether a boot distribution has the effect of a dividend, and the elimination of the gain limitation on the amount of boot that can be treated as a dividend under section 356(a)(2). These two changes to current law are desirable. Otherwise, present law operates well and should be retained.

*C. 1985 SFC Proposed Tax Treatment of the Acquiring Corporation*

*1. Treatment of Acquiring Corporation in a Straight QSA or QAA*

*a. Nonrecognition Treatment*

The acquiring corporation has nonrecognition under current section 1032 upon the issuance of its stock in a QSA or a QAA. It also has nonrecognition under current Treasury Regulation section 1.61-12(c) upon the issuance of its securities.

*b. Acquiring Corporation's Basis in a QAA*

In a QAA, the acquiring corporation's basis in the target's assets is dependent upon whether the acquisition is a *Carryover Basis Acquisition* or a *Cost Basis Acquisition*. In the case of a QAA where the Cost Election is *not* made, the transaction is treated as a *Carryover Basis Acquisition*,<sup>228</sup> and the acquiring corporation, or any affiliated acquiring corporation, takes a carryover basis in the target's assets.<sup>229</sup> In a QAA for which the Cost Election is made, the acquiring corporation takes a cost basis in the target's assets under current section 1012 of the Code.

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<sup>228</sup> Proposed § 365(a), 1985 SFC Proposals, *supra* note 6, at 117.

<sup>229</sup> Proposed § 362(b)(1), *id.* at 110.

c. *Acquiring Corporation's Basis in a QSA*

i. *In General*

The 1985 SFC Proposals provide that in any QSA, whether a *Carryover Basis Acquisition* or a *Cost Basis Acquisition*, the acquiring corporation's basis in the target's stock is generally equal to the net adjusted basis of the target's assets.<sup>230</sup> Proposed section 1020(a) provides that at any given time, the parent's (*i.e.*, controlling corporate shareholder) basis in the stock of a controlled subsidiary is equal to the parent's "applicable percentage of the net inside basis of such controlled corporation (1) increased by the balance of the premium account as of such time, and (2) reduced by the balance of the discount account at such time."<sup>231</sup>

The net inside basis is defined as the subsidiary's aggregate adjusted basis in its assets reduced by the aggregate adjusted issue prices of any outstanding liabilities of such corporation.<sup>232</sup> The term "applicable percentage" is defined as the percentage of the subsidiary's stock by value that is held by the parent.<sup>233</sup>

Control for the purpose of Proposed section 1020(a) has the same meaning as in Proposed section 366(c), which adopts the definition in current section 1504 of the Code,<sup>234</sup> and the stock counted to meet the test does not include nonvoting preferred stock described in current section 1504(a)(4).<sup>235</sup> When stock of a corporation is owned by several members of an affiliated group, all the stock is treated as owned by one member of the group for purposes of determining whether control exists,<sup>236</sup> and if the members of the group own stock of the subsidiary representing control, each member owning such stock is treated as a controlling corporate shareholder.<sup>237</sup>

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<sup>230</sup> Proposed § 1020(a), *id.* at 160-61.

<sup>231</sup> *Id.* This provision applies generally and not just in QSAs. *See id.* The premium and discount accounts are discussed below. *See infra* notes 238-43 and accompanying text.

<sup>232</sup> Proposed § 1020(c), *id.* at 162.

<sup>233</sup> Proposed § 1020(e)(3), *id.* at 167.

<sup>234</sup> Proposed § 1020(e)(1)(A), *id.* at 166. The text in current § 1504(a)(2) of the Code provides that the controlling corporation must possess at least 80% of the corporation in question and have a value at least equal to 80% of the total value of that corporation's stock. *See* I.R.C. § 1504(a)(2).

<sup>235</sup> Proposed § 1020(e)(4), 1985 SFC Proposals, *supra* note 6, at 167.

<sup>236</sup> Proposed § 1020(e)(1)(B)(i), *id.* at 166.

<sup>237</sup> Proposed § 1020(e)(1)(B)(ii), *id.* at 166-67.

*ii. Treatment of Premiums and Discounts*

The purpose of the premium and discount accounts required under Proposed section 1020(d) is to adjust for the possible difference between the amount an acquiring corporation pays for a target's stock and the basis that the acquiring corporation would otherwise have for the target's stock under Proposed section 1020.

Under this rule, if as of the control date<sup>238</sup> an acquiring corporation's basis (determined without respect to Proposed section 1020) in the stock of a newly acquired target is greater or less than the applicable percentage of the net inside basis of the target, then the acquiring corporation must establish either a premium or discount account.<sup>239</sup>

In the event that the acquiring corporation makes an early disposition of the target's stock, these accounts are designed to eliminate the difference between the purchase price paid by the acquiring corporation for the target's stock and the acquiring corporation's basis in such stock under the net-adjusted-basis rule. For example, assume that an acquiring corporation pays \$100 for the target's stock and the net adjusted basis for the target's assets is \$80. If the acquiring corporation immediately sells the target's stock for \$100, it would recognize no gain or loss by operation of the premium account.

The initial premium and discount accounts are adjusted as follows. If the target (subsidiary) recognizes gain on the disposition of its assets (other than the gain that the acquiring corporation can establish is allocable to periods after the acquisition date),<sup>240</sup> then the discount account is increased by such gain and the premium account is decreased by such gain.<sup>241</sup> Thus, in the above example where there is a premium of \$20, if the target recognizes gain that

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<sup>238</sup> The control date is, in the case of a QSA, the acquisition date and, in any other case, the later of the date control is acquired or January 1, 1986. Proposed § 1020(d)(7), *id.* at 165-66.

<sup>239</sup> Proposed § 1020(d)(1), *id.* at 162-63. For example, if an acquiring corporation pays \$100 in cash for all the stock of a target in a QSA qualifying as a *Carryover Basis Acquisition*, and the target's net inside basis for its assets is \$80 (*i.e.*, there is unrealized appreciation in the target's assets), then the acquiring corporation must set up a premium account of \$20. If, on the other hand, the target's inside basis is \$120 (*i.e.*, there is unrealized depreciation in the target's assets), the acquiring corporation must set up a discount account of \$20.

<sup>240</sup> Proposed § 1020(d)(3)(B), *id.* at 163.

<sup>241</sup> Proposed § 1020(d)(3)(A), *id.*



is not shown by the acquiring corporation to be allocable to the post-acquisition period, such gain up to \$20 will reduce the premium account. However, because the gain net of the tax liability will generate an increase in the target's net inside basis, the parent's basis in the subsidiary's stock will in effect reflect the realization of such gain. If the reduction in the premium account would reduce the account below zero, then the parent must establish a discount account to the extent of the excess reduction.<sup>242</sup>

The premium and discount accounts are eliminated in the taxable year after the third taxable year beginning after the acquisition date.<sup>243</sup> Needless to say these adjustments are extremely complex.

### *iii. Allocation of Basis Upon Disposition of Stock*

If a parent disposes of part of the stock of a subsidiary, the basis of the stock disposed of is determined by the ratio of the value of such stock to the value of the stock held before the disposition.<sup>244</sup>

If the parent is not in control of the subsidiary after the disposition, the basis of the retained stock is equal to the portion of the pre-disposition basis not allocated to the stock disposed of, and the premium or discount accounts are eliminated.<sup>245</sup> The Secretary is authorized to waive this provision if the primary purpose of the disposition is tax avoidance.

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<sup>242</sup> Proposed § 1020(d)(3)(C), *id.* at 163-64. Similarly, where there is a \$20 discount because the subsidiary's net inside basis is \$120 and the parent paid only \$100, any gain recognized by the subsidiary not shown by the parent to be allocable to the post-acquisition period will generate an *increase* in the discount account. *See supra* note 239.

On the other hand, if the subsidiary recognizes loss after the acquisition date and the parent does not establish that such loss is allocable to the pre-acquisition period, then the discount account is reduced (but not below zero) by such loss. Proposed § 1020(d)(4)(A), 1985 SFC Proposals, *supra* note 6, at 163-64. For example, where there is a \$20 discount, if the target recognizes a loss of \$20 that is not shown to be allocable to the pre-acquisition period, the discount account would be entirely eliminated. In such case the net inside basis will, after taking account of tax effect, equal the initial amount paid for the stock.

If the parent establishes that a portion of the loss is allocable to the pre-acquisition period, then in the case of a premium account, the account is increased by such loss, and in the case of a discount account, the account is first reduced (but not below zero) by the portion of such loss not so allocable, then reduced by the pre-acquisition loss. If the discount account by reason of such pre-acquisition loss would be reduced below zero, the parent will establish a premium account and credit that account with the amount of such excess reduction. Proposed § 1020(d)(4)(B)(i), (ii), *id.*

<sup>243</sup> Proposed § 1020(d)(5), *id.* at 165.

<sup>244</sup> Proposed § 1020(b)(1), *id.* at 161.

<sup>245</sup> Proposed § 1020(b)(2), *id.* at 161-62.

d. *The Cost Election for QSAs and QAAs*

i. *In General*

The Cost Election is made by the acquiring corporation in a QSA.<sup>246</sup> Both the acquiring corporation and the target must make the Cost Election in a QAA,<sup>247</sup> unless the QAA is effectuated as a merger or consolidation. As noted below in the discussion of the consistency requirement, the Cost Election is made separately for the target and for each of its controlled subsidiaries.<sup>248</sup>

The Cost Election cannot be made if one or more persons in control of the acquiring corporation immediately after the acquisition date were in control of the target immediately before (1) the acquisition date in the case of a QAA, or (2) the 12-month acquisition period in the case of a QSA.<sup>249</sup> Control for this purpose means the ownership of stock possessing at least fifty percent of either the total combined voting power or the total value of all the stock.<sup>250</sup> The attribution rules of current section 318, with certain modifications, also apply in determining control.<sup>251</sup> If the acquiring corporation acquires from unrelated parties at least fifty percent in value of the target's stock during a 12-month period ending on the acquisition date, then the Cost Election can be made with respect to a QAA, since acquisitions from unrelated parties during this one-year period are ignored in determining whether the acquiring corporation had control of the target.<sup>252</sup>

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<sup>246</sup> Proposed § 365(b)(1), *id.* at 117. The time for making the Cost Election is the later of the fifteenth day of the ninth month after the acquisition or the time specified in regulations. Proposed § 365(g)(1), *id.* at 126. The election is irrevocable. Proposed § 365(g)(2), *id.* An acquiring corporation that makes a Cost Election is required to give notice of such election to any controlling corporate shareholder of the target. Proposed § 365(g)(3), *id.*

<sup>247</sup> Proposed § 365(b)(3), *id.* at 118-19.

<sup>248</sup> See *infra* notes 270-72 and accompanying text.

<sup>249</sup> Proposed § 365(d)(1), 1985 SFC Proposals, *supra* note 6, at 121. If the transaction would be a QAA but for the fact that the target does not distribute its assets within the 12-month period as required by Proposed § 364(c)(2), the transaction is treated as a QAA for which a carryover-basis election is made (except as provided in regulations), but only for determining the basis of the target's assets. Proposed § 365(d)(2), *id.* at 122. Also, for purposes of determining whether a QAA has occurred, "substantially all" is substituted for the 90-70 test in Proposed § 364(c)(1)(B). Proposed § 365(d)(3), *id.*

<sup>250</sup> Proposed § 365(d)(4), *id.* at 122-23.

<sup>251</sup> Proposed § 365(d)(5), *id.* at 123-24.

<sup>252</sup> Proposed § 365(d)(4)(B), *id.* at 122-23. An unrelated party under Proposed § 365(d)(4)(B)(ii) includes any uncontrolled (50%) party determined by application of the current § 318 attribution rules. *Id.* at 123.

For example, if the acquiring corporation purchases sixty percent of the target's stock in a tender offer that occurs within a 12-month period, the Cost Election could be made for the subsequent merger of the target into the acquiring corporation. However, if the target's stock had been held by the acquiring corporation for more than a year at the time of the merger, the Cost Election could not be made and the acquiring corporation would have to take a carry-over basis in the target's assets.

If a Cost Election cannot be made because the acquisition is from a related party and, therefore, the QA is treated as a *Carry-over Basis Acquisition*, then any asset acquired from the target before a QA is treated as acquired in the *Carryover Basis Acquisition*, except as provided in regulations.<sup>253</sup> For purposes of this consistency rule, stock that is acquired as part of a QSA is not considered an asset.<sup>254</sup> Also, any acquisition during the consistency period by a member of an affiliated group of which the acquiring corporation is a member is treated as made by the acquiring corporation.<sup>255</sup>

## ii. Carryover Treatment for Intangibles

If the Cost Election is made, the acquiring corporation may, notwithstanding the consistency rules discussed below, elect to treat any unamortizable intangible as having been acquired in a carry-over basis acquisition.<sup>256</sup> In such case, the acquiring corporation in a QAA or the target in a QSA will take as its basis for such intangibles the target's pre-acquisition basis,<sup>257</sup> and the target will not recognize gain on the transfer of such assets. "Unamortizable intangible" is defined as any intangible property that is of a character not subject to depreciation under current section 167 and is either goodwill or property designated in the regulations as being of a type similar to goodwill.<sup>258</sup> No election may be made for property described in current section 1031(a)(2) (e.g., stocks and securities) or section 1221(1) (inventory).<sup>259</sup>

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<sup>253</sup> Proposed § 365(c)(3), *id.* at 120.

<sup>254</sup> Proposed § 365(c)(6), *id.* at 121.

<sup>255</sup> Proposed § 365(c)(5), *id.*

<sup>256</sup> Proposed § 365(b)(2), *id.* at 117-18.

<sup>257</sup> Proposed § 362(b)(1), *id.* at 110.

<sup>258</sup> Proposed § 365(b)(2)(B), *id.* at 118.

<sup>259</sup> Proposed § 365(b)(2)(C), *id.*

The effect of this provision is to permit acquiring corporations to carve out of a *Cost Basis Acquisition* the unamortizable intangibles acquired from the target. Ostensibly this election out of cost basis treatment will be made in almost every (if not every) case, because it prevents the immediate tax liability that otherwise would accrue from acquiring such unamortizable intangibles that have no offsetting future cost recovery other than the recovery of basis in a subsequent taxable sale.

This election-out provision results in treatment similar to that given goodwill under current section 337; that is, the target has no gain on a sale of goodwill in a section 337 transaction. Under present law, however, the acquiring corporation would have a cost basis in the goodwill.

*e. The Cost Election Consistency Requirement*

There is a consistency requirement for both QSAs and QAAs. Under this rule, if the acquiring corporation acquires an asset from the target during the "consistency period," and that asset and other assets acquired in a subsequent QA were held by the target during the consistency period, then all such assets and all other assets (including those acquired in the QA) are treated as having been acquired in a *Cost Basis Acquisition*.<sup>260</sup> For this purpose, an acquiring corporation that makes a QSA of a target is treated as having acquired the target's assets.<sup>261</sup>

This constructive Cost Election does not apply if the first acquired asset was acquired in a QA that is a *Carryover Basis Acquisition* (or the acquiring corporation elects, pursuant to regulations, to treat the asset as so acquired) and a Cost Election is not made in the subsequent QA.<sup>262</sup> The constructive Cost Election treatment also does not apply if the asset was acquired in the ordinary course of business or in a transaction specified in the regulations.<sup>263</sup>

In the case of a QSA, the consistency period is (1) the one-year period before the beginning of the 12-month acquisition period, (2) the acquisition period, and (3) the one-year period after the acqui-

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<sup>260</sup> Proposed § 365(c)(1), *id.* at 119.

<sup>261</sup> Proposed § 365(c)(4), *id.* at 120.

<sup>262</sup> Proposed § 365(c)(2), *id.* at 119-20.

<sup>263</sup> Proposed § 365(c)(2)(B), (C), *id.* at 120.

sition date.<sup>264</sup> In the case of a QAA, the consistency period is the period consisting of the one-year period before and after the acquisition date.<sup>265</sup> The acquisition date is the first day on which there is a QSA or a QAA.<sup>266</sup>

To illustrate this consistency provision, assume that on February 1, 1985, the acquiring corporation purchased an asset from the target, and on April 1, 1985, the acquiring corporation acquired the target in a QSA or a QAA for which no explicit Cost Election was made. The QSA or QAA is, therefore, nominally a *Carryover Basis Acquisition*. However, since (1) the target held the asset during the 12-month period before the QSA or the QAA, (2) the acquiring corporation acquired the asset during the consistency period, and (3) the asset was purchased, although the QSA or QAA is nominally a *Carryover Basis Acquisition*, both the asset and the subsequent QA are treated as having been acquired in a *Cost Basis Acquisition*.<sup>267</sup> Alternatively, if either the asset itself was acquired in a QA for which a Cost Election was not made, or the acquiring corporation elects to treat the asset as having been acquired in a carryover basis transaction (except as provided by regulations), then there is no constructive Cost Election for the subsequent QA.<sup>268</sup> The acquiring corporation takes a carryover basis in both the purchased asset and the assets acquired in the QA, and the target has no gain or loss on the sale of the asset or in the QA.

Additionally, the term "asset" does not include stock acquired as part of a QSA.<sup>269</sup> Thus, using the above example, if the asset that was acquired was stock of a subsidiary of the target in a QSA of such subsidiary, and if the Cost Election had been made with respect to such subsidiary, the subsequent *Carryover Basis Acquisition* of the target would not be affected by the prior *Cost Basis Acquisition* of the subsidiary. This rule reverses the anti-selective step-up in basis rules of current section 338.

The 1985 SFC Proposals explain that the cost or carryover basis election is to be made on a corporation-by-corporation basis. This result is apparently reflected in the 1985 SFC Proposals in the fol-

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<sup>264</sup> Proposed § 366(a)(4)(A), *id.* at 127-28.

<sup>265</sup> Proposed § 366(a)(4)(B), *id.* at 128.

<sup>266</sup> Proposed § 366(a)(2), *id.* at 127.

<sup>267</sup> Proposed § 365(c)(1), *id.* at 119.

<sup>268</sup> Proposed § 365(c)(2)(A), *id.*

<sup>269</sup> Proposed § 365(c)(6), *id.* at 121.

lowing manner. First, the consistency requirement does not apply to an acquisition of stock of a subsidiary of the target.<sup>270</sup> Second, an acquiring corporation is treated as owning stock of a corporation using the attribution rules of current section 318 and is treated, for purposes of determining whether the acquiring corporation has made a QSA of a target subsidiary, as having "acquired" such stock of the target subsidiary on the acquisition date of the QSA of the target.<sup>271</sup> Consequently, if an acquiring corporation has a QAA or a QSA with respect to a target, there is automatically a QSA for any eighty-percent directly or indirectly controlled subsidiary of the target. Therefore, a Cost Election can be made separately with respect to the target and each of its controlled subsidiaries.<sup>272</sup>

Finally, where a target is acquired in a QAA by a tax-exempt corporation, a foreign corporation, or a regulated investment company, a Cost Election is deemed to have been made, subject to certain exceptions.<sup>273</sup>

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<sup>270</sup> *Id.*

<sup>271</sup> Proposed § 364(d)(1), *id.* at 114.

<sup>272</sup> The draft bill in the 1983 SFC Original Proposals had another consistency rule that is not contained in the 1985 SFC Proposals. In the 1983 bill, in the case of an acquisition of a target in a QSA or a QAA where (1) the acquiring corporation also made a QSA of a target affiliate during the consistency period, and (2) the target affiliate held an asset that was held by the target during the 12-month period ending on the acquisition date, such asset was treated as if it had been held by the target at the time of the acquisition of the target. See 1983 Proposed § 392(c)(2)(B), 1983 SFC Original Proposals, *supra* note 5. "Target affiliate" is defined as any corporation that was at any time during the consistency period in the same affiliated group with the target. See 1983 Proposed § 393(a)(3), *id.* See generally Thompson, *supra* note 5, at 192. For example, assume that on February 1, 1985, a target contributes an asset to a subsidiary, and the acquiring corporation immediately acquires all of the stock of the subsidiary in a QSA. The acquiring corporation makes a Cost Election with respect to the subsidiary. On April 1, 1985, the acquiring corporation acquires the target in a QSA or QAA and does not make the Cost Election. In that case, the asset that was contributed to the subsidiary would be treated as if it had been acquired in the *Carryover Basis Acquisition* of the target. This rule would prevent abuse of the entity election provision by pre-acquisition transfers of assets within the target group. No reason is given in the 1985 SFC Proposals for deletion of this provision. Possibly this type of situation would be covered by the regulations to be issued under Proposed § 365(c)(2)(C) of the 1985 SFC Proposals.

<sup>273</sup> Proposed § 365(f), *id.* at 125-26.

## 2. Treatment of Acquiring Corporation and Its Subsidiaries in Multi-Corporation QSAs and QAAs

The 1985 SFC Proposals would amend current section 1032(a) to provide that a corporation does not have gain or loss upon the issuance of stock of a corporation that is in direct or indirect control of the issuing corporation,<sup>274</sup> significantly expanding section 1032. Since under the Proposals a parent's basis for its subsidiary's stock is at all times equal to the net inside basis of the subsidiary's assets (subject to the premium or discount account),<sup>275</sup> there is an automatic adjustment to the parent's basis for its subsidiary's stock in an acquisition by the subsidiary of the target's stock or assets.

### D. Suggested Approach to Tax Treatment of the Acquiring Corporation

Since it has been suggested previously that the basic reorganization concept of current law should be retained, it follows that the 1985 SFC Proposals' treatment of the acquiring corporation in a QAA or QSA should also be rejected. It would appear that if the 1985 SFC Proposals are adopted, there will be few *Cost Basis Acquisitions*, because, except where the target has significant net operating losses, the discounted present value of the tax benefits to be received from a Cost Election will not offset the tax that will be due upon making the election. Further, it is difficult to imagine that any taxpayer would make a Cost Election without also making the election for carryover basis treatment of intangibles.

The one change suggested by the 1985 SFC Proposals that should be adopted is to amend current section 1032 to provide that a corporation does not have gain or loss upon the issuance of stock of a corporation that is in direct or indirect control of the issuing corporation. Otherwise, current treatment of the acquiring corporation in an acquisitive reorganization should be retained, that is, the acquiring corporation should have nonrecognition treatment upon the issuance of its stock and securities<sup>276</sup> and should take a

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<sup>274</sup> Proposed § 1032(a)(2), *id.* at 177.

<sup>275</sup> Proposed § 1020(a), *id.* at 160-61.

<sup>276</sup> See I.R.C. § 1032.

carryover basis in the target's assets.<sup>277</sup>

The method provided in the 1985 SFC Proposals to determine a parent corporation's basis in its subsidiary's stock by reference to the net inside basis of the subsidiary's assets, as adjusted by discount and premium accounts should be rejected because of the complexity of the discount and premium accounts and the harsh results that could result once the accounts are eliminated three years after the acquisition. The issue of a parent's basis in its subsidiary's stock would be more appropriately dealt with by amending the consolidated return regulations.

#### *E. 1985 SFC Proposed Tax Treatment of Target*

The tax treatment of the target in a QSA or QAA will depend upon whether the transaction is a *Carryover Basis Acquisition* or a *Cost Basis Acquisition*.

A *Carryover Basis Acquisition* is defined to include a QAA with respect to which a Cost Election is not made.<sup>278</sup> In the case of a QAA that is a *Carryover Basis Acquisition*, the target corporation does not recognize gain or loss.<sup>279</sup>

If a Cost Election is made with respect to a QAA, then the target corporation recognizes gain or loss on the transaction.<sup>280</sup> The character and amount of the gain is determined under the fragmentation rule of *Williams v. McGowan*.<sup>281</sup> The Cost Election in the context of a QAA is discussed further below.

#### *F. Suggested Tax Treatment of Target*

The current law treatment of the target in a reorganization under current sections 361 and 358 of the Code should be retained.<sup>282</sup>

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<sup>277</sup> See *id.* § 362(b).

<sup>278</sup> Proposed § 365(a), 1985 SFC Proposals, *supra* note 6, at 117.

<sup>279</sup> Proposed § 361(a), *id.* at 106.

<sup>280</sup> Proposed § 361(b)(2), *id.* at 107-08.

<sup>281</sup> 152 F.2d 570 (2d Cir. 1945).

<sup>282</sup> If a target exchanges its property solely for stock of an acquiring corporation, the target does not recognize any gain or loss under § 361(a). Under § 361(b), if the target receives both stock and boot, the target recognizes the gain realized to the extent of the boot, unless the boot is distributed to its shareholders. Pursuant to § 357(a), liabilities transferred from a target to an acquiring corporation do not constitute boot in the absence of tax avoidance motives. See I.R.C. § 357(b). Under § 358, the target corporation's basis in the stock or



V. 1985 SFC PROPOSED AND SUGGESTED ALTERNATIVE TREATMENT  
OF REGULAR LIQUIDATIONS

A. 1985 SFC Proposed Provisions Governing Regular  
Liquidations

1. 1985 SFC Proposed Tax Treatment of Liquidating  
Corporations

a. In General

Under the 1985 SFC Proposals, current section 336 would be repealed,<sup>283</sup> and current section 311 would be amended to govern both current and liquidating distributions.<sup>284</sup> The distributing corporation would recognize gain on any current or liquidating distribution with respect to its stock; thus, the *General Utilities* doctrine would be repealed for both current and liquidating distributions.<sup>285</sup> Loss would be recognized in the case of a distribution that is "pursuant to a plan of complete liquidation."<sup>286</sup> Gain or loss would be determined "as if the property had been sold to the distributee at its fair market value."<sup>287</sup> These gain and loss recognition rules would not apply in a liquidation of a subsidiary into a parent where the parent takes a carryover basis under section 334(b),<sup>288</sup> or in a section 355 spin-off,<sup>289</sup> and the gain recognition rule would not apply in a distribution of stock of certain controlled corporations.<sup>290</sup> The collapsible corporation provision under current section 341<sup>291</sup> would be repealed.<sup>292</sup>

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securities it receives from the acquiring corporation is a substituted basis, decreased by the boot received and increased by the gain recognized.

<sup>283</sup> Bill § 121(1), 1985 SFC Proposals, *supra* note 6, at 142.

<sup>284</sup> Proposed § 311, *id.* at 140-42.

<sup>285</sup> Proposed § 311(a)(1), *id.*; *see also* *General Util. & Oper. Co. v. Helvering*, 296 U.S. 200 (1935); *infra* note 299.

<sup>286</sup> Proposed § 311(a)(2), *id.*

<sup>287</sup> Proposed § 311(a)(3), *id.*

<sup>288</sup> Proposed § 311(b), *id.*

<sup>289</sup> Proposed § 311(c), *id.*

<sup>290</sup> Proposed § 311(d), *id.*

<sup>291</sup> Under current § 341, if a corporation is a "collapsible corporation" (a device for converting ordinary income into capital gain), any long-term capital gain recognized upon a sale of stock or a liquidation is treated as ordinary income.

<sup>292</sup> Bill § 121(4), 1985 SFC Proposals, *supra* note 6, at 142.

b. *Character of Corporation's Gain or Loss*

As a backstop to the repeal of the collapsible corporation provision and to prevent a corporation from receiving capital gain on property which in the hands of the shareholder would be ordinary income, a new provision would be added which would require a corporation to recognize ordinary income on the sale or disposition of certain property.<sup>293</sup> The recharacterization applies to any dispositions of property by the corporation within three years of the contribution to capital of such property,<sup>294</sup> provided that any gain on such property would be ordinary income if sold by the shareholder.<sup>295</sup> The recharacterization also applies to any property "(A) which is manufactured, constructed, produced, purchased or otherwise acquired by any corporation, and (B) the gain on which would, if held by 1 or more shareholders of such corporation holding a substantial portion of the stock of such corporation, be treated as ordinary income,"<sup>296</sup> provided such property is disposed of within three years of the date on which the holding period of such corporation with respect to the property begins.<sup>297</sup>

2. *1985 SFC Proposed Tax Treatment of Shareholders on Regular Liquidations*

a. *In General*

Shareholders would continue to have capital gain or loss under section 331 upon the liquidation of a corporation.<sup>298</sup> As noted below, in view of the repeal of *General Utilities*<sup>299</sup> in the liquidation context, shareholders of certain small corporations would receive a

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<sup>293</sup> Proposed § 1257, *id.* at 178-80.

<sup>294</sup> Proposed § 1257(c)(1), *id.*

<sup>295</sup> Proposed § 1257(b)(1), *id.*

<sup>296</sup> Proposed § 1257(b)(2)(B), *id.*

<sup>297</sup> Proposed § 1257(c)(1)(B), *id.* For purposes of this provision members of an affiliated group are treated as one corporation. Proposed § 1257(c)(2), *id.*

<sup>298</sup> Because under the Proposals a liquidating "collapsible corporation" would recognize ordinary income upon liquidation, it no longer would be necessary to impose ordinary income treatment at the shareholder level.

<sup>299</sup> *General Util. & Oper. Co. v. Helvering*, 296 U.S. 200 (1935) (a corporation generally does not recognize income upon liquidation). This doctrine was essentially codified in current § 336. Gain is recognized, however, with respect to recapture of depreciation, LIFO reserves, and tax benefit items. As discussed above, the 1985 SFC Proposals would repeal § 336. See *supra* text accompanying note 283.

basis increase in their stock to reflect the extra corporate-level tax with respect to certain long-held capital assets.<sup>300</sup>

Current section 333 would continue to apply but in a modified form.<sup>301</sup> Proposed section 333 does not contain a one-month liquidation requirement or dividend element as is provided in current section 333. A qualified electing shareholder would recognize gain on liquidation of a domestic corporation only to the extent of the receipt of the money and property described in current section 1031(a)(2)(B)-(E) (*i.e.*, stocks, securities, etc.).<sup>302</sup> A "qualified electing shareholder" is any shareholder who (1) is a shareholder at the time of the adoption of the plan, (2) elects to have section 333 apply, and (3) in the case of a shareholder who is eligible for the basis adjustment provision for the corporate tax on long-held capital assets,<sup>303</sup> elects not to have the basis adjustment.<sup>304</sup> As under current law, a shareholder who makes this election takes as his basis for the property received the basis for his stock decreased by the amount of money received and increased by gain recognized.<sup>305</sup>

A parent corporation would continue to qualify for nonrecognition treatment under section 332 upon the liquidation of an eighty-percent controlled subsidiary. However, the control test under section 332 would be made by reference to current section 1504(a)(2).<sup>306</sup>

#### *b. Shareholder Basis Adjustment for Corporate-Level Tax on Long-Held Capital Assets*

The 1985 SFC Proposals provide for an increase in the basis of the stock of shareholders upon liquidation of certain corporations or the disposition of a corporation in a QA that is a *Cost Basis Acquisition*.<sup>307</sup> The purpose of the basis adjustment is to mitigate the effect of the corporate tax in the liquidation or *Cost Basis Acquisition*.<sup>308</sup> The special basis adjustment applies in a "section

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<sup>300</sup> Proposed § 1060(b)(1), 1985 SFC Proposals, *supra* note 6, at 168-69.

<sup>301</sup> Proposed § 333, *id.* at 142-43.

<sup>302</sup> Proposed § 333(a), *id.*

<sup>303</sup> See *infra* text accompanying notes 310-12.

<sup>304</sup> Proposed § 333(b), 1985 SFC Proposals, *supra* note 6, at 142-43.

<sup>305</sup> See I.R.C. § 334(c).

<sup>306</sup> Bill § 131(b), 1985 SFC Proposals, *supra* note 6, at 145-46.

<sup>307</sup> Proposed § 1060, *id.* at 168-76.

<sup>308</sup> For a discussion of the policy justifications of shareholder relief for the corporate tax,

1060 transaction," which is defined as "any (A) qualified acquisition, or (B) liquidation of any corporation to which section 331 applies (determined without regard to any election under section 333)."<sup>309</sup>

The basis adjustment is available only to "eligible shareholders," defined in Proposed section 1060(e)(1) as "any person who holds stock of the applicable corporation [the target in a QA or the liquidating corporation<sup>310</sup>] on the transaction date [the acquisition date in a QA or the date all the assets other than those retained to meet claims are distributed in complete liquidation<sup>311</sup>], but only if the gain on the disposition of such stock on such date would be long-term capital gain."<sup>312</sup>

If a shareholder is not an "eligible shareholder" because the gain would not be long-term capital gain, then the eligible shareholder is "the person (if any) — (i) who disposed of such stock during the 6-month period ending on the transaction date, and (ii) with respect to whom gain or loss on such disposition was long-term capital gain or loss."<sup>313</sup> For example, if a shareholder of a target corporation sells stock within six months before the target is acquired in a QA that is a *Cost Basis Acquisition* and realizes long-term capital gain on the sale, then that shareholder, and not the new shareholder who is the shareholder on the acquisition date, is the "eligible shareholder."

The amount of the increase in basis in the eligible shareholder's stock is equal to "the lesser of — (1) such shareholder's pro rata share of the aggregate basis adjustment, or (2) the excess of — (A) the fair market value of such stock immediately before such increase, over (B) the adjusted basis of such stock at such time."<sup>314</sup> Thus, the basis increase cannot cause the adjusted basis of the stock to exceed the fair market value of the stock.

To determine the aggregate basis adjustment, it is first necessary

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see Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 *Taxes* 516 (1974); ALI Proposals, *supra* note 4, at 134-41. Both Blum and the ALI propose a shareholder credit for the corporate capital gains tax.

<sup>309</sup> Proposed § 1060(f)(1), 1985 SFC Proposals, *supra* note 6, at 174-75.

<sup>310</sup> Proposed § 1060(f)(2), *id.* at 175.

<sup>311</sup> Proposed § 1060(f)(3), *id.*

<sup>312</sup> Proposed § 1060(e)(1)(A), *id.* at 173.

<sup>313</sup> Proposed § 1060(e)(1)(B), *id.* at 174.

<sup>314</sup> Proposed § 1060(a), *id.* at 168.

to determine the "long-held capital asset tax," which, in essence, is the corporate tax attributable to capital assets that have been held by the corporation for more than five years. The term is defined as

the excess (if any) of —

(i) the sum of the taxes imposed . . . on —

(I) the applicable corporation, and

(II) any qualified subsidiary of the applicable corporation, for each taxable year which includes the disposition period, over

(ii) the sum of such taxes determined without regard to any gain or loss on the disposition of any long-held capital asset by such corporation or subsidiary during the disposition period.<sup>315</sup>

A qualified subsidiary is a subsidiary of the target for which a QA is made for both the target and the subsidiary.<sup>316</sup> The term "long-held capital asset" is defined as "any capital asset the holding period of which at the time of the disposition is 5 years or more."<sup>317</sup> The disposition period is the 12-month period ending with the transaction date.<sup>318</sup> Thus, the long-held capital asset tax is the portion of the corporate tax attributable to the disposition of long-held capital assets during the 12-month period prior to the acquisition date of the QA or the completion of the liquidation.

Having determined the meaning of the "long-held capital asset tax," it is now possible to determine the "aggregate basis adjustment," defined as "the excess of — (A) an amount equal to — (i) the long-held capital asset tax, divided by (ii) 0.28, over (B) the long-held capital asset tax."<sup>319</sup> Thus, for example, if a target in a QA realizes a \$100 gain that is attributable to a long-held capital asset and as a result incurs a \$28 tax on this gain under current section 1201, there is a long-held capital asset tax of \$28, and the

<sup>315</sup> Proposed § 1060(b)(3), *id.* at 169-70.

<sup>316</sup> Proposed § 1060(b)(4)(A), *id.* at 170-71.

<sup>317</sup> Proposed § 1060(b)(4)(C), *id.* at 171. There is a special rule for current § 1231 gains from the disposition of long-held capital assets. If the § 1231 gains from such dispositions exceed the § 1231 losses from such dispositions, such gains are taken into account in computing the long-held capital asset tax "only to the extent of the lesser of the amount by which — (i) such gains exceed such losses, or (ii) the section 1231 gains for all property disposed of during the disposition period exceed the section 1231 losses for all property disposed of during such period." Proposed § 1060(b)(3)(B), *id.* at 170. Section 1231 gains and losses have the meaning given such terms in current § 1231(a)(3). Proposed § 1060(b)(4)(D), *id.* at 171.

<sup>318</sup> Proposed § 1060(b)(1), *id.* at 175.

<sup>319</sup> Proposed § 1060(b)(1), *id.* at 168-69.

aggregate basis adjustment is \$72 computed as follows:

$$\begin{array}{r} \text{28 (Long-held capital asset tax)} \\ \hline \text{.28} \end{array} - 28 \begin{array}{l} \text{(Long-held} \\ \text{capital} \\ \text{asset tax)} \end{array} = 72$$

The resulting aggregate basis adjustment is, therefore, the corporate after-tax proceeds attributable to the taxable gain on long-held capital assets. The theory of the basis increase is to eliminate the shareholder tax with respect to such after-tax proceeds.

The basis adjustment is phased out for corporations with a fair market value in excess of \$1,000,000.<sup>320</sup> Under the phase-out provision, “[t]he aggregate basis adjustment shall be reduced (but not below zero) by 10 percent for each \$100,000 by which the value of the stock (including stock described in section 1504(a)(4)) of the applicable corporation on the transaction date exceeds \$1,000,000.”<sup>321</sup> Thus, for corporations with stock valued in excess of \$2,000,000, there is no aggregate basis adjustment. The Secretary is given authority to promulgate regulations that disregard the disposition of stock or assets if the “primary purpose” is to avoid the phase-out limitations.<sup>322</sup>

A shareholder’s pro rata share of the aggregate basis adjustment is determined by the ratio of the fair market value of the stock held by the shareholder (as of the transaction date) to the fair market value of all the stock of the corporation on such date.<sup>323</sup> The stock with respect to which the basis adjustment is made does not include preferred stock described in section 1504(a)(4).<sup>324</sup> The increase in the eligible shareholder’s basis is made at the beginning of the transaction date,<sup>325</sup> except where the eligible shareholder disposes of his stock before the transaction date, in which case the basis increase is made immediately before the disposition of the stock.<sup>326</sup>

Within sixty days of the due date of the corporate return with respect to the QA or complete liquidation, the acquiring corpora-

<sup>320</sup> Proposed § 1060(b)(2)(A), *id.* at 169.

<sup>321</sup> *Id.*

<sup>322</sup> Proposed § 1060(b)(2)(B), *id.*

<sup>323</sup> Proposed § 1060(e)(2), *id.* at 174.

<sup>324</sup> Proposed § 1060(f)(5), *id.* at 175.

<sup>325</sup> Proposed § 1060(f)(6)(A), *id.* at 176.

<sup>326</sup> Proposed § 1060(f)(6)(B), *id.*

tion or liquidating corporation must provide each shareholder of the target or liquidating corporation with his pro rata share of the aggregate basis adjustment and such other information as may be prescribed.<sup>327</sup>

Finally, if the aggregate basis adjustment is determined to be in excess of the proper amount, a twenty-percent tax on such excess is imposed on the corporation.<sup>328</sup>

## *B. Suggested Approach to the Tax Treatment of Liquidating and Current Distributions*

### *1. Suggested Approach to the Taxation of Shareholders*

From a tax policy perspective there should be a parity of tax treatment of liquidating and nonliquidating distributions. In general, if liquidating distributions are taxed more favorably than nonliquidating distributions, there will be an incentive to accumulate earnings until a corporation is liquidated. Under both current law and the 1985 SFC Proposals, there is a built-in incentive at the shareholder level to accumulate income in order to realize that income in a liquidation or sale transaction. This occurs because the shareholder in a liquidation or sale under either scheme receives capital gain treatment (assuming under current law that the corporation is not collapsible),<sup>329</sup> whereas in a dividend distribution the shareholder receives ordinary income treatment.<sup>330</sup>

Notwithstanding the incentive for liquidation and sales, this approach is sensible in a tax system that has a preferred tax rate for transactions involving the sale or exchange of capital assets. If the shareholder receives capital gain on the sale of his stock, he should receive capital gain on the liquidation of his corporation. Thus, the basic capital gain rule of current section 331 should be retained. For the reasons set out below in the discussion of the tax consequences of the liquidating corporation, the collapsible corporation provisions of current section 341 should be repealed. The availabil-

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<sup>327</sup> Proposed § 1060(c), *id.* at 171-72. Since in a QSA the return for the target is not due until 8½ months after the acquisition date, there could be a substantial period of time between the due date for the individual shareholder's return and the date on which the shareholder receives the information regarding the basis increase.

<sup>328</sup> Proposed § 1060(d), *id.* at 172-73.

<sup>329</sup> See I.R.C. §§ 331, 1001, 1221, 1222.

<sup>330</sup> See I.R.C. §§ 301, 312, 316.

ity of section 333 should be broadened as suggested in the 1985 SFC Proposals.<sup>331</sup>

For reasons set out below in the tax treatment of the liquidating corporation, shareholders should not be given a basis adjustment for the corporate-level tax. Accordingly, the basis adjustment provision suggested in the 1985 SFC Proposals<sup>332</sup> should be rejected.

## 2. Suggested Approach to the Taxation of the Liquidating Corporation

Although the discussion here focuses principally on liquidating distributions, for reasons that will become apparent it is also necessary to consider current sales, current distributions, and liquidating sales. The guiding principle should be that current and liquidating distributions should not be used as a back-door escape hatch for avoiding corporate-level taxes. A corporation is a taxable entity and should be subject to taxation on income and gains that are realized or accrued during the time the corporation holds property. It follows that, as a general principle, the *General Utilities* doctrine<sup>333</sup> should be repealed for both current and liquidating distributions.

A second reason for repealing the *General Utilities* doctrine is that it imposes artificial tax restrictions or incentives on the sale or exchange of property held by a corporation, instead of providing uniform treatment of (1) ordinary sales of property, (2) ordinary distributions of property, (3) liquidating sales of property, and (4) liquidating distributions of property. This is a more precise statement of the neutrality principle which the 1985 SFC Proposals use to justify changing current law.<sup>334</sup> In this type of system the corporation will not decide whether to hold, sell, or distribute property on the basis of the tax benefits or detriments associated with the

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<sup>331</sup> See *supra* text accompanying notes 301-05. Such a broadening is consistent with a proposal made by James Lewis in 1959, in which he suggested that shareholders not be taxed on in-kind liquidating distributions and that they should take as their basis in the property received the basis of their stock with adjustments for cash received and gain realized. Lewis, *A Proposed New Treatment of Corporate Distributions and Sales in Liquidations*, 3 Tax Revision Compendium 1643, 1646 (1959) (House Committee on Ways and Means).

<sup>332</sup> See *supra* notes 307-28 and accompanying text.

<sup>333</sup> See *supra* note 299.

<sup>334</sup> See 1985 SFC Proposals, *supra* note 6, at 38.



particular manner of disposition. Thus, free alienability of assets is promoted, and, therefore, one can expect that there would be a more economically efficient use of assets.

A third reason for repealing the *General Utilities* doctrine for items such as inventory, portfolio shares, and land or buildings not used in the active conduct of a trade or business is that if these items are left free from tax in a liquidation there will be a strong incentive to invest corporate earnings and assets in these items in order to convert the earnings and any subsequent appreciation into capital gains at the shareholder level in a liquidation. This incentive puts undue pressure on the accumulated earnings tax,<sup>335</sup> and with regard to inventory, is at the heart of the problem at which the collapsible corporation provisions are directed. Thus, nonrecognition treatment for these items in a liquidation amounts to a windfall to the corporation and its shareholders.

Although this third reason is probably not applicable to equipment used in the trade or business, the first two reasons for repealing the *General Utilities* doctrine clearly apply to equipment. Further, since equipment is subject to full recapture of depreciation in a liquidation under current law, in most cases the full appreciation in equipment is presently subject to taxation because it is rare that equipment appreciates above its original cost.

An exception to the recognition rule should be drawn, however, for the sale or distribution in partial or complete liquidation of goodwill (or going concern value), and of land and buildings used in the active conduct of the corporation's trade or business. The case for an exception for goodwill is the strongest, but there are also strong reasons for exempting land and buildings used in the active conduct of a trade or business.

Four basic reasons support a goodwill exception. First, goodwill is an asset that is bound up with the overall business operation; it is not an asset that generally can be segregated from the other assets of a business and sold separately. Thus, goodwill is in economic substance an asset that is reflective of the ownership rights in the business. It should, therefore, be taxed only at the ownership level (*i.e.*, the shareholder level) and not at the corporate level. Second, since goodwill is unamortizable, it is not an item that is included in the corporate tax base for depreciation pur-

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<sup>335</sup> See I.R.C. §§ 531-537.

poses, and, therefore, it is not appropriate to include it in the corporate tax base in a liquidation.<sup>336</sup> A third reason for not taxing goodwill in a liquidation is that there is no incentive to accumulate goodwill in a corporation as is the case for inventory and passive assets. Finally, to subject goodwill to tax in a liquidation would impose a harsh penalty tax for operating in the corporate form. If a business is operated in the sole proprietorship or partnership form, there is one tax on the liquidation of goodwill (as well as other property). If a double tax were imposed on the disposition of goodwill in a corporate liquidation there would be a powerful reason not to operate in the corporate form. Indeed, to impose such a double tax on goodwill would in essence impose a penalty tax on liquidations. This is not true, however, with respect to inventory, passive assets and equipment.

These third and fourth reasons for exempting goodwill also carry the day for land and buildings (except for full recapture of depreciation) held in the active conduct of the corporation's trade or business ("actively used land and buildings"). First, corporations should be subject to full recapture of depreciation with respect to buildings because the depreciation deductions reduced the corporation's taxable income (or increased its net operating losses) and there is no reason to exempt any recapture of depreciation upon a sale or distribution. Second, it is unlikely that a corporation would invest its earnings in actively used land and buildings for the purpose of avoiding gain on such property in a liquidation. Thus, there is no apparent reason for imposing a penalty tax on such property in a liquidation. Further, land and buildings that are integral to the business are unlikely to be completely disposed of,

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<sup>336</sup> The ALI Proposals make these same two points:

Current standard doctrine is that a purchaser cannot deduct or amortize payments for the purchase of goodwill. If the purchaser cannot deduct or amortize such payments, then they will have no effect on the computation of taxable income from the conduct of the business to which they relate. It may then seem excessively harsh to insist upon both corporate and individual capital-gain taxes on the transferor. Moreover, it can then be argued that such payments need not be included in computing taxable gains of a liquidating transferor corporation, because they are so much like the excess over corporate basis that one might pay to purchase shares directly from individual stockholders.

ALI Proposals, *supra* note 4, at 121; see also Land, *Unallocated Premium in Corporate Acquisitions Under the American Law Institute Subchapter C Proposals*, 34 Tax Law. 341 (1981).

except in a liquidation. In fact, they are in many respects practically inalienable (except when replaced) as is the case with goodwill.

The standard developed under current section 355<sup>337</sup> for determining whether a corporation is engaged in the active conduct of a trade or business could be used in determining whether land and buildings are used in the active conduct of the corporation's trade or business. Also, as a disincentive for a corporation to invest needlessly in what purports to be actively used land and buildings, an ordinary income tax should apply to any land or buildings that were claimed to be actively used but were found not to be. In this connection, it should be noted that the President's recent tax proposals would treat any gain on the disposition of current section 1231 property (other than land) as ordinary income.<sup>338</sup>

Finally, if a double tax were imposed in taxable liquidations of goodwill and actively used land and buildings, shareholders would have even more of an incentive to sell out in a tax-free reorganization to a large acquiring corporation. There is no reason to have the tax system biased in favor of such conglomeration.

For these reasons, there should be an explicit exemption for goodwill and actively used land and buildings (except for full recapture of depreciation) from the corporate-level tax in a liquidation or current distribution.<sup>339</sup> There should also be an exception for both current and liquidating distributions of stock of a subsidiary in a transaction that qualifies for tax-free treatment under current section 355 (*e.g.*, a spin-off).

Further, the principle that there should be uniformity of treatment of ordinary sales, ordinary distributions, liquidating sales, and liquidating distributions should also apply to the disposition of goodwill and actively used land and buildings. Therefore, in a partial liquidation of a corporation, whether by sale of assets of a

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<sup>337</sup> See I.R.C. § 355(b)(2).

<sup>338</sup> See The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity 168 (1985).

<sup>339</sup> See ABA Tax Section Task Force, *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 Tax Law. 625, 626 (1984) (suggesting that gain or loss not be recognized by the distributing corporation, except to the extent recognized under current law, on the distribution of (1) goodwill, (2) capital assets and § 1231 property held for more than three years which are distributed in complete liquidation, and (3) all the distributing corporation's stock of a controlled subsidiary).

trade or business followed by a distribution of the proceeds or by a straight distribution of those assets, the selling or distributing corporation should not have taxable gain or loss with respect to the sale or distribution of goodwill and actively used land and buildings (except for full recapture of depreciation). The shareholder-level tax in this case is sufficient.<sup>340</sup> This rule for partial liquidations would eliminate the application of the *Court Holding* doctrine,<sup>341</sup> where a corporation distributes its property in a partial liquidation that is tax-free under current section 311(d)(2)(A)(i) and the shareholders shortly thereafter sell the property.

The above rules would put the taxation of ordinary distributions under section 311 in complete parity with the taxation of liquidating distributions under section 336. As will be seen below, the approach taken here for the treatment of the sale of goodwill and actively used land and buildings in a partial or complete liquidation would permit section 337 to be repealed.

In view of the suggestion that corporations be taxed on the liquidating distribution of property other than goodwill and actively used land and buildings, the collapsible corporation provisions of current section 341 should be repealed. There is no need for such a provision where a corporation is taxed on its ordinary income assets in a liquidation, since there would be no incentive for shareholders to use a corporation to convert what otherwise would be ordinary income into capital gain in a liquidation. Indeed, the double tax on the liquidating distribution (first the corporate-level tax, which would be at ordinary rates on non-capital assets, and then the shareholder-level tax) would be a powerful disincentive.

On the other hand, the provision in the 1985 SFC Proposals that would determine the character of gain with respect to corporate assets by reference to the character such assets would have in the hands of certain controlling shareholders should be adopted.<sup>342</sup>

The shareholder basis adjustment that is contained in the 1985 SFC Proposals<sup>343</sup> should be rejected for the following reasons.

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<sup>340</sup> However, to qualify for nonrecognition treatment upon the distribution of goodwill or actively used land or buildings in a partial or complete liquidation, the parties would have to enter into an allocation agreement, discussed below. See *infra* section VI.B.

<sup>341</sup> See *supra* notes 32-34 and accompanying text.

<sup>342</sup> See Proposed § 1257, 1985 SFC Proposals, *supra* note 6, at 178-80. A similar concept was added to the partnership provisions by the Tax Reform Act of 1984. See I.R.C. § 724.

<sup>343</sup> See *supra* text accompanying notes 307-28.

First, such an adjustment is in effect an unjustified erosion of the corporate tax base. With the exception proposed here for goodwill and actively used land and buildings, there should be no significant tax deterrent to liquidating sales and distributions. Second, the credit would only be available in liquidating distributions and sales and would, therefore, be an artificial incentive for corporations to hold assets until liquidation. Third, the extension in the 1985 SFC Proposals of the basis adjustment only to shareholders of small corporations would be an unneeded incentive for taxpayers to organize (or reorganize through tax-free spin-offs under current section 355) their business enterprises in such a way as to take advantage of the credit.

#### VI. 1985 SFC PROPOSED AND SUGGESTED ALTERNATIVE TREATMENT UPON SALE OF A CORPORATION'S ASSETS FOLLOWED BY LIQUIDATION

##### *A. 1985 SFC Proposed Tax Treatment to Target Corporation and Its Shareholders Upon Sale of Its Assets Followed by Liquidation*

In a sale of assets by a target corporation that qualifies as a QAA, the target's shareholders would have nonrecognition treatment to the extent they exchange stock or securities in the target for stock or securities in the acquiring corporation, and they would have gain and possibly a dividend with respect to any boot received.<sup>344</sup> The shareholders may receive an adjustment to the basis of their shares for a portion of the corporate-level tax paid, if any, on long-held capital assets.<sup>345</sup>

Under the Proposals, current section 337 would be repealed.<sup>346</sup> In general, a target corporation would have gain or loss on the sale of its assets even though such sales are made as part of a liquidation. However, if the target corporation disposes of its assets in a QAA and a Cost Election is not made, then the transaction is treated as a *Carryover Basis Acquisition* and the target corporation does not have gain or loss on the sale.<sup>347</sup> In the context of a

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<sup>344</sup> Proposed §§ 354, 356, 1985 SFC Proposals, *supra* note 6, at 83-88, 94-100; *see also supra* notes 182-211 and accompanying text.

<sup>345</sup> Proposed § 1060, 1985 SFC Proposals, *supra* note 6, at 168-77; *see also supra* notes 307-28 and accompanying text.

<sup>346</sup> Bill § 121(2), 1985 SFC Proposals, *supra* note 6, at 142.

<sup>347</sup> Proposed § 361(a), *id.* at 106.

sale by a target corporation of its assets, a QAA is defined to include a transaction in which an acquiring corporation "acquires at least—(i) 70 percent of the gross [FMV], and (ii) 90 percent of the net [FMV], of the assets of [the target] corporation held immediately before the acquisition of such assets."<sup>348</sup> Since the 90-70 test is made "immediately before" the transaction, the target can dispose of assets the acquiring corporation does not want by either distributing the unwanted assets or selling the unwanted assets and distributing the proceeds prior to transferring the wanted assets to the acquiring corporation. It should be noted, however, that any such distribution or sale would be a taxable transaction. A transaction can qualify as a QAA without respect to the nature or mix of consideration paid by the acquiring corporation.

If a Cost Election is made with respect to a QAA, then the target corporation recognizes gain or loss on the transaction,<sup>349</sup> except to the extent carryover basis treatment is elected for unamortizable intangibles acquired from the target.<sup>350</sup> A Cost Election in a QAA is made by both the acquiring corporation and the target corporation (other than in a statutory merger or consolidation).<sup>351</sup> The Cost Election cannot be made if the acquiring corporation and the target are under common control.<sup>352</sup> Control here means ownership of fifty percent of the stock.<sup>353</sup> However, this exception for commonly controlled corporations does not apply if the acquiring corporation acquired from an unrelated party at least fifty percent of the FMV of the target's stock during the 12-month period ending on the acquisition date.<sup>354</sup>

Except where an election is made to treat the target as a member of the selling consolidated group,<sup>355</sup> a target corporation with respect to which a Cost Election is made in a QAA that is a statutory merger or consolidation will "not be treated as a member of an affiliated group with respect to the gain or loss recognized on

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<sup>348</sup> Proposed § 364(c)(1)(B), *id.* at 113.

<sup>349</sup> Proposed § 361(b)(2), *id.* at 107-08.

<sup>350</sup> Proposed § 365(b)(2), *id.* at 117-18.

<sup>351</sup> Proposed § 365(b)(1), (3), *id.* at 117-19.

<sup>352</sup> Proposed § 365(d), *id.* at 121-24.

<sup>353</sup> Proposed § 365(d)(4)(A), *id.*

<sup>354</sup> Proposed § 365(d)(4)(B), *id.*

<sup>355</sup> Proposed § 361(b)(3)(B), *id.* at 108-09.

such acquisition."<sup>356</sup> The effect of this provision is to prevent the target corporation from using losses from other members of the affiliated group to offset the taxable gain from the transaction, except where a proper election is made. This provision is similar to the rule of present section 338(h)(9).

It should be noted that if the acquiring corporation pays cash for the target's assets in a QAA for which the Cost Election is made, there will be both a corporate- and shareholder-level tax, except that the corporate-level tax with respect to unamortizable intangibles can be avoided if the special carryover-basis election for such intangibles is made.<sup>357</sup>

### *B. Suggested Alternative Approach to the Taxation of the Target in a Section 337 Transaction*

Current section 337<sup>358</sup> should be replaced with a simple provision providing that upon the sale by a corporation of the assets of a trade or business in connection with a partial or complete liquidation of that business, the corporation does not recognize gain with respect to the sale of goodwill or actively used land and buildings (except for full recapture of depreciation). This provision would essentially put all sales of goodwill and actively used land and buildings on a parity with all distributions of such property.

As a condition to this nonrecognition treatment, the parties would have to enter into an allocation agreement, pursuant to which they would explicitly agree to be bound, allocating the purchase price among the assets sold. The allocation agreement would have to be filed with the returns of the target and acquiring corporations for the period during which the partial or complete liquidation occurred.

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<sup>356</sup> Proposed § 361(b)(3)(A), *id.* at 108.

<sup>357</sup> Proposed § 365(b)(2), *id.* at 117-18.

<sup>358</sup> I.R.C. § 337. Under § 337, a corporation (other than a collapsible corporation) that adopts a plan of liquidation and liquidates within 12 months may receive nonrecognition treatment on a sale of its assets occurring after the adoption of the plan, except with respect to certain recapture items. This provision is designed to relieve the pressure of determining whether a distribution to shareholders followed by a sale of assets is in fact a sale by the corporation under *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), or alternatively, a sale by the shareholders under *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950).

The corporation's shareholders have capital gain under § 331 unless the corporation is collapsible.

The requirement of an allocation agreement would reduce substantially the instances in which the Service is whipsawed in sales of businesses. This often happens where there is no allocation agreement and the buyer allocates all or substantially all of the purchase price to depreciable property or inventory, while the seller allocates all or substantially all of the purchase price to assets (such as goodwill) that either produce capital gain or, even worse, tax-free treatment in a section 337 transaction.

This requirement of an allocation agreement should substantially improve compliance and substantially reduce litigation over allocation issues. Further, the general rule of taxation on partial and complete liquidations, except for goodwill and actively used land and buildings, would put the parties in essentially inconsistent positions (except in the case of a liquidation where the target has a net operating loss), and, therefore, would promote realistic allocations of purchase price to the properties that are sold.

#### VII. 1985 SFC PROPOSED AND SUGGESTED ALTERNATIVE TREATMENT OF PURCHASE OF TARGET'S STOCK

##### A. 1985 SFC Proposed Tax Treatment of Target Corporation and Its Shareholders Upon Purchase of Its Stock

In a QSA, the target's shareholders have nonrecognition treatment to the extent they receive stock or securities of the acquiring corporation in exchange for stock or securities of the target.<sup>359</sup> They also may receive a basis adjustment to their stock for the target's corporate-level tax in respect of long-held capital assets if a Cost Election is filed by the acquiring corporation.<sup>360</sup>

Current section 338 would be repealed.<sup>361</sup> Upon the purchase of a target corporation's stock there is no change in the basis of its assets, unless there is a QSA and a Cost Election is made. In the absence of a Cost Election, the transaction is treated as a *Carry-over Basis Acquisition*.<sup>362</sup> A taxpayer that makes the Cost Election<sup>363</sup> can nevertheless elect carryover-basis treatment for

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<sup>359</sup> See generally *supra* text accompanying notes 182-227.

<sup>360</sup> Proposed § 1060, 1985 SFC Proposals, *supra* note 6, at 168-77.

<sup>361</sup> Bill § 121(3), *id.* at 142.

<sup>362</sup> Proposed § 365(a), *id.* at 117.

<sup>363</sup> The Cost Election in a QSA is made by the acquiring corporation. Proposed § 365(b)(1), *id.* The election must be made before the later of the 15th day of the 9th month



unamortizable intangibles.<sup>364</sup> As noted above, there is no consistency requirement like the anti-selectivity requirement contained in current section 338, and an acquiring corporation may, therefore, make entity-by-entity Cost Elections for the target and its affiliates.<sup>365</sup>

If the Cost Election is made with respect to the target or any of its controlled subsidiaries, such corporation is treated (1) as having sold all of its assets at the close of the acquisition date in a transaction in which gain or loss is recognized, and (2) as being a new corporation that purchased all of such assets as of the beginning of the day after the acquisition date.<sup>366</sup> This is similar to the concept contained in current section 338(a). The assets are deemed to be sold and purchased for their FMV on the acquisition date.<sup>367</sup>

### *B. Suggested Approach to the Taxation of Purchases of the Target's Stock*

The basic rules of section 338<sup>368</sup> should be retained; however, the target should have full gain on the deemed sale of its assets, except with respect to goodwill and actively used land and buildings (except for full recapture of depreciation).<sup>369</sup> Since the target is controlled by the acquiring corporation, there is no need for an allocation agreement, and since there is tax-free treatment only with

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following the month in which the acquisition occurs or the date prescribed in regulations. Proposed § 365(g), *id.* at 126.

<sup>364</sup> Proposed § 365(b)(2), *id.* at 117-18.

<sup>365</sup> See *supra* notes 270-73 and accompanying text.

<sup>366</sup> Proposed § 361(b)(1)(A), 1985 SFC Proposals, *supra* note 6, at 106-07.

<sup>367</sup> Proposed § 361(b)(1)(B), *id.*

<sup>368</sup> Under current law, the target's stockholders have capital gain or loss on the sale of their stock, unless the target is a collapsible corporation. Upon the purchase of a target corporation's stock there is no change in the basis of its assets unless a § 338 election is made. Thus, a purchase of stock without more could be viewed as a carryover-basis transaction. If an acquiring corporation purchases at least 80% of the stock of a target corporation within a 12-month period and the acquiror thereafter makes an election under § 338, the target is treated as selling its assets to itself in a transaction qualifying under § 337, in which case the target is treated as a new corporation with a stepped-up basis in its assets. Under the consistency requirement, the § 338 step-up rule applies to all controlled subsidiaries of the target. See I.R.C. § 338(e), (f).

<sup>369</sup> The Joint Committee on Taxation has pointed out that there are Congressional proposals to make a § 338 election mandatory in hostile takeovers. See Staff of Joint Comm. on Tax'n, *Tax Aspects of Hostile Takeovers and Mergers* (Pamphlet prepared for Senate Finance Committee, April 22, 1985), reported in *Daily Tax Report* (BNA) J1, J17 (April 22, 1985).

respect to goodwill and actively used land and buildings, the acquiring corporation faces a built-in conflict between an allocation to such assets and to other assets.

### VIII. CONCLUSIONS<sup>370</sup>

#### A. *The 1985 SFC Proposals Should be Rejected*

The essential approach of the 1985 SFC Proposals in classifying acquisitions as QAAs and QSAs should be rejected. There are, however, certain elements of the Proposals that should be incorporated into present law.

The Proposals are not supported by the reasons given for their adoption. In criticizing current law, the 1985 SFC Proposals say that current law is "seriously flawed" because it "lacks consistency," is "unnecessarily complex," and is "subject to manipulation."<sup>371</sup> In addition, the Proposals say that current law needs to be more neutral, and as an example of the lack of neutrality the Proposals say present law is biased in favor of liquidations.<sup>372</sup> All of these things are true, but each of these concerns can be addressed in a much more direct and less wrenching manner than that taken by the 1985 SFC Proposals.

Further, the 1985 SFC Proposals themselves are seriously flawed in several significant respects. First, the Proposals are extremely complex. Second, the Proposals are subject to manipulation. For example, a corporation that is going to be liquidated could sell all of its assets for cash (possibly paying no tax because of net operating losses) before being acquired in a QAA or QSA, allowing the shareholders to receive stock of the acquiror tax-free.

Third, the Proposals would substantially erode the tax base by significantly expanding the number of merger and acquisition transactions that would allow tax-free treatment at the shareholder level. Thus, the provisions would undermine the like-kind exchange provision (current section 1031), the purpose of which is to ensure taxation on swaps of property, except in very limited circumstances. Congress amended current section 1031 in the Tax

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<sup>370</sup> This conclusion is the basis of testimony given by the author on September 30, 1985, in hearings before the Senate Finance Committee, Subcommittee on Taxation and Debt Management, on The Subchapter C Revision Bill of 1985.

<sup>371</sup> 1985 SFC Proposals, *supra* note 6, at 37.

<sup>372</sup> *Id.* at 38.

Reform Act of 1984<sup>373</sup> to make it clear that a swap of partnership interests does not qualify for like-kind treatment. In allowing tax-free treatment on the swap of stock in a QAA or QSA where cash is the predominant part of the consideration, the Proposals run completely counter to this congressional policy judgment concerning section 1031.

Fourth, if the Proposals are enacted, cost-basis acquisitions will be rare because, unless the target has net operating losses, it is highly unlikely that the present value of the future tax benefits arising from a step up in basis to the acquiror will offset the tax immediately due from the target. This may indeed make it more likely that small corporations will be sold to large corporations that do not need the benefits of a step up in basis. Thus, in its zeal to repeal the *General Utilities* doctrine, the 1985 SFC Proposals may have implicitly codified and even extended the doctrine by allowing taxpayers in a cash sale of a business followed by a liquidation to avoid completely corporate-level taxation of the target by completing the transaction as a *Carryover Basis Acquisition*. It also seems highly unlikely that any taxpayer would ever make a Cost Election without also making the special carryover election for goodwill. Thus, the Proposals may, in essence, have exempted goodwill from taxation in a liquidating sale, except for the uninitiated who fail to make the special goodwill election.

Fifth, the Proposals themselves lack neutrality. The shareholder-level basis adjustment for the corporate-level tax on long-held capital assets of small corporations (*i.e.*, corporations with a value of less than \$2 million) will be an incentive (1) for a small corporation to hold its capital assets until liquidation, and (2) for shareholders to rearrange corporate activities into multiple small corporations (possibly through tax-free spin-offs of subsidiaries under section 355) in order to qualify for the special shareholder basis adjustment.

## B. Suggested Alternative Approach

### 1. In General

It is suggested as an alternative to the 1985 SFC Proposals that the current law of mergers and acquisitions be amended. Basically,

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<sup>373</sup> Pub. L. No. 98-369, § 77(a), 98 Stat.

the current dichotomy between tax-free reorganizations and taxable liquidations should be retained. The reorganization definition should be revised generally along the lines suggested in the ABA Reorganization Recommendations.<sup>374</sup> In taxable liquidations the *General Utilities* doctrine should be repealed but not for goodwill and actively used land and buildings (except for full recapture of depreciation).

## 2. Revision of the Reorganization Definition

### a. Need for Change

There is no tax policy justification for the disparate treatment of boot, continuity of interest, and "substantially all" tests in the various forms of reorganization, and, therefore, the reorganization definition should be amended to set forth uniform standards for these items. Also, the impact on the continuity-of-interest doctrine of pre- and post-reorganization sales of stock of the acquiring corporation should be clarified. Further, the continuity-of-interest doctrine should not be subject to manipulation by having the corporation that is the real target act as the acquiring corporation in order to increase the amount of boot that can be paid. Finally, although a relative size requirement should not be adopted, the amount of permissible boot should be a function of the relative size of the target and the acquiring corporation.

### b. Basic Continuity-of-Interest Requirement

For each of the forms of acquisitive reorganization there should be a minimum amount of consideration that is underlying voting common stock of the acquiring corporation (or of the parent corporation of the group of which the acquiring corporation is a member, or of such other corporation as may be specified in the regulations). The minimum amount of voting common stock would be determined by reference to the permissible boot that could be used. By allowing use of stock of the ultimate parent (or of any other corporation specified in regulations) as suggested by the 1985 SFC Proposals, the *Groman* and *Bashford* doctrines would be more clearly overridden.

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<sup>374</sup> See *supra* note 2.

*c. Pre- and Post-Reorganization Sales*

In determining whether the continuity-of-interest test is satisfied, pre-reorganization sales by the target's shareholders should be disregarded, except for sales within the period two years before the reorganization to (or arranged by) the acquiring corporation. Any such sales should be considered boot. This applies to distributing the unwanted assets or selling the unwanted assets and distributing the proceeds prior to transferring the wa such sales are not "pursuant to an arrangement negotiated or agreed upon prior to such [reorganization],"<sup>375</sup> the standard under current law for tax-free spin-offs.

*d. Reverse Acquisition Provision*

A reverse acquisition provision similar to the one suggested in the 1985 SFC Proposals should be adopted for reorganizations. If shareholders of the nominal target end up with more than fifty percent of the stock of the nominal acquiring corporation, then the nominal target should be treated as the acquiring corporation. This type of provision would prevent evasion of the boot limitation rule, and thereby insure the integrity of the continuity-of-interest rule.

*e. Permissible Boot*

Although there should not be a relative size requirement for reorganization treatment, the amount of permissible boot should be a function of the relative size of the target and the acquiring corporation. The smaller the target relative to the acquiror, the smaller the amount of permissible boot. The minimum amount of permissible boot should be ten percent and the maximum forty percent as set forth in the following chart:

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<sup>375</sup> I.R.C. § 355(a)(1)(B).

% of Acquiring Corporation's Voting Common Held By the Target's Shareholders <u>As a Result of the Reorganization</u>	Amount of Permissible Boot
Less than 5%	10%
At least 5% but not more than 10%	20%
At least 10% but not more than 20%	30%
More than 20%	40%

*f. The "Substantially All" Test*

The "substantially all" test for the "C" reorganization should be measured immediately before the reorganization as suggested in the ABA Reorganization Recommendations. Additionally, the test should be eliminated for the forward and reverse subsidiary mergers.

*g. Elimination of the Bausch & Lomb Problem*

The principle in the *Bausch & Lomb* case should be eliminated along the lines suggested in the ABA Reorganization Recommendations. That case holds that in a "C" reorganization where the acquiror holds stock of the target, the assets received by the acquiror upon the liquidation of the target are considered as received partially in exchange for the target's stock rather than in exchange for the stock of the acquiror.

*h. General Relationship Between Section 351 and the Reorganization Provisions*

Section 351 should be amended to make it clear that nonrecognition treatment is not available in a section 351 transaction that is part of a transaction that takes on the form of an acquisitive reorganization. A similar provision is contained in the 1985 SFC Proposals.

*i. Incorporation of Active Trade or Business Under Section 351 Prior to Reorganization*

Section 351 should be amended to permit a tax-free incorporation of an actively conducted trade or business (whether previously conducted by a corporation, a sole proprietorship, or a partner-

ship) prior to and in contemplation of the acquisition of the new corporation in an acquisitive reorganization. The 1985 SFC Proposals contain a similar provision, but only for corporate transferors. There is no reason for not extending the same treatment to sole proprietorships and partnerships as long as the business is actively conducted. This will eliminate an artificial limitation on the form in which a business is operated.

*j. The Continuity of Business Enterprise and Business Purpose Doctrines*

These doctrines stand as safeguards against abuse of the reorganization provisions and should be retained. The essential elements of the regulations dealing with continuity of business enterprise should be codified. The business purpose doctrine should continue in the merger and acquisition area just as it continues in every other area of tax law.

*3. Suggested Tax Treatment of the Parties to a Reorganization*

*a. Target's Shareholders*

The present treatment of the target's shareholders basically should be retained. However, the suggestion in the 1985 SFC Proposals that the determination of whether a boot distribution has the "effect of a dividend" be made under the standard set forth in *Wright* should be adopted.

*b. The Acquiring Corporation*

The present treatment of the acquiror should be retained, except that section 1032 should be amended, as suggested in the 1985 SFC Proposals, to provide that a corporation does not have gain or loss upon the issuance of stock of a corporation that is in direct or indirect control of the issuing corporation.

*c. The Target*

The current tax treatment of the target (*i.e.*, general nonrecognition treatment) should be retained.

#### 4. Regular Liquidations

##### a. Treatment of the Shareholders

The shareholders in a liquidation should continue to receive capital gain treatment, and the collapsible corporation provisions should be repealed. The availability of the section 333 nonrecognition treatment should be broadened as suggested in the 1985 SFC Proposals.

##### b. Treatment of the Liquidating Corporation

In general, the conclusion in the 1985 SFC Proposals that the *General Utilities* doctrine should be repealed is correct. However, because of the nature of goodwill and actively used land and buildings, such assets should not be subject to taxation in a liquidation, except for full recapture of depreciation on such buildings.

One reason for repealing the *General Utilities* doctrine for items such as inventory, portfolio shares, and land or buildings not used in the active conduct of a trade or business is that if these items are free from tax in a liquidation there will be a powerful incentive to invest corporate earnings in these items in an attempt to convert the earnings and subsequent appreciation into capital gain in a subsequent liquidation. Equipment, which is now subject to full recapture of depreciation, should also be subject to full taxation in a liquidation.

There should, however, be an exception to the recognition rule for the sale or distribution in partial or complete liquidation of goodwill (or going concern value) and of actively used land and buildings. If a tax were imposed on goodwill and actively used land and buildings, there would be an unjustified bias in the tax system in favor of tax-free reorganizations involving large acquiring corporations.

The standard developed under section 355 for determining whether a corporation is engaged in the active conduct of a trade or business should be used in determining whether land and buildings are used in the active conduct of the corporation's trade or business. Also, as a disincentive for a corporation needlessly to invest in what purports to be actively used land and buildings, the gain on any land or buildings claimed to be actively used but found not to be should be taxed at ordinary income rates.

Further, in order not to impose artificial restrictions on the free



alienability of property held by a corporation, there should be uniform treatment of (1) ordinary sales of property, (2) ordinary distributions of property, (3) liquidating sales of property, and (4) liquidating distributions of property. This principle should apply to goodwill and actively used land and buildings. Therefore, upon the partial or complete liquidation of a corporation (whether by sale of assets followed by distribution of the proceeds, or by straight distribution of the assets) the selling or distributing corporation should not have taxable gain or loss on the sale or distribution of goodwill or actively used land or buildings (except for full depreciation recapture).

Finally, there should also be an exemption from the corporate-level tax for the current or liquidating distribution of stock in a tax-free transaction under section 355 (e.g., a spin-off).

The shareholder should not receive a basis adjustment for the corporate-level tax on long-held capital assets as is proposed for certain small corporations by the 1985 SFC Proposals. The credit would be an artificial incentive to hold assets until liquidation and to organize business enterprise as small corporations in order to qualify for the basis adjustment.

##### *5. Taxation of the Target in a Section 337 Sale*

Under the approach suggested above for the taxation of the liquidating corporation, section 337 would be repealed and replaced with a simple provision that provides that upon the sale by a corporation of the assets of a trade or business in connection with a partial or complete liquidation, the corporation does not recognize gain or loss with respect to goodwill and actively used land and buildings (except for full recapture of depreciation). The collapsible corporation provision should be repealed, but a provision should be adopted, similar to that proposed by the 1985 SFC Proposals, that would determine the character of a corporation's gain on the disposition of certain assets by reference to the character the gain would have had in the hands of certain controlling shareholders.

As a condition to nonrecognition treatment, the parties should have to enter into an allocation agreement specifically allocating the purchase price among the assets to be sold. The agreement would have to be filed with the Service. The requirement of an allocation agreement should help prevent the Service from getting

whipsawed in a sale transaction.

#### 6. Stock Purchases Under Section 338

Section 338 should be retained, and if the election is filed, the target should have full gain on the deemed sale of its assets other than goodwill and actively used land and buildings (except for full recapture of depreciation).

#### *C. Analysis of This Suggested Approach Against the Backdrop of the 1985 SFC Proposals' Reasons for Change*

Each of the eleven detailed reasons for change given in the 1985 SFC Proposals<sup>376</sup> are addressed by the suggested alternative approach outlined above.

First, under the suggested alternative approach, a uniform amount of boot would have to be used in the various forms of reorganization. Second, all of the forms of acquisitive reorganization would have a voting common stock requirement, and, consequently, uniformity in the type of consideration that could be paid. This requirement for tax-free reorganization treatment would bring the tax requirements closer to the requirements for a pooling of interest for accounting purposes. Third, the *Groman* and *Bashford* restraints on the use of grandparent stock in a reorganization would be eliminated. Fourth, the forward and reverse subsidiary mergers would have the same requirements. Fifth, the "substantially all" anomaly in the current "C" reorganization and forward and reverse subsidiary mergers would be eliminated. Sixth, as a result of the modification of the "substantially all" concept, strip-down transactions would be allowed in each form of reorganization. Seventh, any continuing uncertainty regarding the overlap between a "C" and "D" reorganization can be resolved. Eighth, the uncertainty in the application of the continuity-of-interest doctrine would be eliminated by adopting specific rules governing pre- and post-reorganization dispositions of stock. Ninth, the uncertainty surrounding the parameters of the business enterprise doctrine would be eliminated by codifying the essential elements of the regulations dealing with the doctrine. The uncertainty in the application of the business purpose doctrine should

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<sup>376</sup> 1985 SFC Proposals, *supra* note 6, at 38-41; *see supra* text accompanying note 61.

not be cause for elimination of this doctrine in the merger and acquisition context since it pervades all other aspects of the federal income tax law. Tenth, with the suggested beefing-up of the continuity-of-interest doctrine by (1) reducing the amount of boot that can be used in a reorganization, (2) requiring a basic level of voting common stock of the acquiror as consideration, (3) eliminating the overlap of section 351 and the reorganization rules, and (4) adopting a reverse acquisition provision, the anomalous results from the linkage between the shareholder-level consequences and the corporate-level consequences would be eliminated. Finally, the adoption of uniform standards for each form of reorganization and the clarification of the application of the continuity-of-interest doctrine should substantially reduce any whipsaw possibilities due to the reorganization definition.

## PANEL DISCUSSION ON MERGERS AND ACQUISITIONS

*Moderator:*

Roderick A. DeArment  
 Chief of Staff to Senate Majority Leader  
 Washington, D.C.

*Panelists:*

George Yin  
 Tax Counsel  
 Senate Finance Committee Staff  
 Washington, D.C.

Professor Bernard Wolfman  
 Harvard University Law School  
 Cambridge, Mass.

Professor Martin D. Ginsburg  
 Georgetown University Law  
 Center  
 Washington, D.C.

Professor Alvin C. Warren, Jr.  
 Harvard University Law School  
 Cambridge, Mass.

Cym H. Lowell  
 Barnes & Thornburg  
 Indianapolis, In.

*Excerpts from panelists' comments:*

YIN: Let me say at the outset that I welcome the opportunity that we are having today to give close scrutiny to the Staff Proposals in the acquisitions area. I know many of you and many of us were quite disappointed that the Treasury decided not to give that level of scrutiny at the recent hearing. Sam was one of the witnesses at our recent hearing and I must confess that when I first saw his testimony a few days before he was to appear, I was rather intrigued by it because right there in the summary of his testimony he stated that the continuity-of-interest doctrine, which of course the Staff Proposals would repeal, should not only be retained but should be strengthened. It reminded me a little bit of a recent drafting session we had on the proposed repeal of section 1231, where there was some concern expressed in the group about the fact that the existence of *General Utilities* might permit a relatively easy circumvention of the proposed repeal of section 1231. Therefore, consideration was offered to possibly repealing *General Utilities*, but one attorney, perhaps sensitive to the controversy surrounding that move, said, "No, let's not repeal *General Utilities*. We don't have to do that. All we need to do is to strengthen

the collapsible corporation rules.”

I'm going to devote my comments to just one issue that Sam raises, continuity of interest, because I think it goes to the core of the difference between the Proposals that he would present and the ones that were presented by the Staff. As I understand it, Sam's rule, for all tax-free reorganizations, would limit the amount of permissible boot that is allowed. And generally speaking, the closer in size the acquiring entity and the target company are, the more boot that could be allowed in the transaction. In contrast, the more disparate in size the two entities are, for example the large conglomerate acquiring Corner Drug Store, Inc., the greater the amount of conglomerate stock that would be required in the acquisition to be tax free, with very little boot allowed. He would provide similar limitations in the case of the amount of voting common stock that would have to be used, again depending on the relative sizes of the entities involved.

I think a fair first question to be raised is: why do we need these rules? What purpose do they serve? Sam points out that ever since 1918, tax-free treatment typically has been limited to transactions where target shareholders retain a continuing interest in the affairs of their corporation by acquiring a stock ownership interest in the acquiring corporation. That's fine. Those certainly are familiar words to people who practice in the corporate tax area. Let's examine how well the rule that he proposes would implement that goal, assuming that that's the goal we have. We know in many public acquisitions there is, generally speaking, a fair amount of arbitrage activity immediately prior to the acquisition, so that at the time of the reorganization, the target company may be owned in whole or in large part by arbitrageurs who acquired their target stock one year, one month, one week, maybe even only one day prior to the acquisition. Would these individuals represent the kind of continuing interest in the target company that should permit a transaction to be treated as tax free? Sam of course proposes a rule for pre-reorganization sales, but as I understand it, it wouldn't apply to your garden-variety arbitrage situation.

Let's turn to after the reorganization. Typically the arbitrageurs in the reorganization will exchange their target stock for stock of conglomerate. And then typically, as is their wont, they will proceed to start selling their conglomerate stock. Six months after the acquisition is over, few if any of the former target shareholders will

continue to own stock in the acquiring company. Sam, here again, would propose a rule for post-reorganization sales, essentially, as I understand it, codifying the *McDonald's* rule which would apply only to prearranged sales. It seems to me that even if we wanted to examine the particular circumstances of each target shareholder and determine whether in fact there was a negotiated, prearranged sale in any particular case, that rule nevertheless would be relatively easy to circumvent. That is, it would be relatively easy to establish that there was no specific post-reorganization sale arranged ahead of time. Thus, we have the situation where before the acquisition the target company is owned largely by arbitrageurs or nonhistoric shareholders, and within a short period after the acquisition, few if any of those former target shareholders continue to own stock in the acquiring company. Those transactions nevertheless would qualify for tax-free treatment under the proposed rule. I wonder, if that is the case, then is the rule truly implementing the goal that we had set out initially? I guess I would suggest that if that theory deserves implementation, and I am not sure that it does, then it seems to me we need a far more rigorous set of rules than the ones that are being proposed here.

Let me turn to a few practical aspects of the proposed changes in the continuity-of-interest doctrine. The first question is: who is going to be helped by these rules? I'm tempted to say the actuaries because now the issue of value or the relative values of the two entities will be an issue in just about every reorganization. Our section 382 proposals are criticized on the same basis, but at least there the value issue only goes to the value of the target company that happens to have losses.

Who would be hurt by these proposals? I would submit that the people hurt by the proposals would probably be the same people that are hurt by the complexity of current law, that is, the closely held corporations. In those cases, value is typically an uncertain issue, and those taxpayers are more likely to be caught unaware of the rule. You see, Eddie, we are looking out for the closely helds.

When would value be determined? Presumably, the relative values of the two entities would be determined as of the time of the reorganization, which means that if there is a change in the relative values between the time when the deal is cut and the actual reorganization is effected, then there could be some unhappy surprises on reorganization day.

How would the relative values be determined? If you turn to page 683 of Sam's paper, he sets out a little matrix. Basically, he would suggest all you need to do is to look at the amount of voting common stock of the acquiring corporation held by the target shareholders as a result of the reorganization. Of course, we know that he doesn't mean that, because in my experience and I am sure in his, a conglomerate rarely appears in the guise of a single corporation. Conglomerate might be tens or hundreds of corporations. So that if you had an acquisition, in fact one that he suggested, where a lower-tier subsidiary is the acquiring corporation of the stock or the assets of the target company, and only stock of that lower-tier subsidiary is used, would he suggest that we just look at the value of that single company or would he suggest we look at the entire acquiring group? Presumably, it would be the entire acquiring group, although I am not exactly sure.

Would the rule be subject to manipulation? Perhaps so, because value would be determined by only the value of the voting common stock of the respective entities, so that to the extent value could be shifted to other equity interests of the respective entities, the rules could be circumvented.

What would the economic effect of the proposal be (and I ask this in deference to Treasury)? It seems to me what we are doing is making it more difficult for conglomerate to acquire Corner Drug Store, Inc. I think it might fairly be said that we don't want to provide undue incentives for that kind of an acquisition. I know that Sam differs with the Staff proposals and would suggest that the Staff proposals do provide those incentives. But I question why we would want to provide disincentives for that kind of an acquisition.

Last, let me just end up by asking: would this be good for the fisc? I'm not sure. It's unclear to me why we would want to put these kinds of barriers on tax-free treatment for these kinds of acquisitions. It seems to me we should focus more on the issue of eliminating the tax-free treatment in cases where a basis step-up is the result; I'm not going to mention the words *General Utilities*, but I will stop right there.

ANDREWS: Sam's paper is a long and interesting document; you have heard a fairly loquacious exposition of what I assure you is only part of it. It goes on and on. I found reading it a very interesting exercise, and a very interesting survey of existing law and of

the Senate Finance Committee proposals. It was interesting because it examines them from a slightly different perspective, and because it introduces an interesting set of proposals of Sam's own.

I want to devote part of my comment to the assertion that in the end there is more consensus between Sam's conclusions and those of the Senate Finance Committee than might appear. That is, he has taken the tough conclusions in the Senate Finance Committee proposals — the restrictions on the *General Utilities* rule and a number of other such things — and he has ultimately come to agree more, I think, than he disagrees with those portions of the proposals, yet from a slightly different rhetorical perspective. What do I mean by rhetorical perspective? Well, I mean this. I think we all love the reorganization provisions. Those of us who live in this area have come to love those provisions, but we love them in somewhat different ways, or with somewhat different consequences. And Sam's love of them leads him to preserve the wonderful romantic distinction that has been elaborated by the Congress and the courts and others over the years to see how far one can move in a more sensible direction without giving up that wonderful dichotomy. And I think he moves a long way toward, as I indicated, the results that the Senate Finance Committee proposals also would arrive at. The other way of loving the reorganization provisions is to love the results they prescribe so much that we don't want them to be confined just to reorganization transactions. That is, we would like to extend the learning of the reorganization provisions to acquisition transactions generally. What is that learning? In a brief comment I'm just going to indicate one aspect of it, and that is that a stock acquisition isn't all that different from an asset acquisition, that those are alternative modes of producing the same result, and that you ought to have the same tax results for both. And if you read through the operative aspects of the acquisition portions of the reorganization provisions, that's what they tell us over and over again: let an asset acquisition and a stock acquisition be treated alike. Have nonrecognition of gain on the transfer of the assets and a carryover of basis, so that the result of an asset acquisition, if it is within the reorganization provisions, will be the same as if you had gone out and purchased the stock.

That brings me back to what I wanted to ask: what really are the points at which Sam doesn't go along with the Senate Finance Committee report? I am oversimplifying, I know, because the hour



is late and time is limited, but I think it is fair to focus on two cases.

One case is a cash purchase of assets of an acquired corporation. In that case, the Senate Finance Committee proposals would say that the purchase can, upon filing of the correct election, be treated on a carryover basis without recognition of gain to the corporate transferor. In a sense, that can be thought of as extending reorganization treatment to a transaction that doesn't hold one scintilla of continuity of interest, and therefore might seem to be a radical kind of proposal. All I am saying here is that it's not radical at all because it is exactly the same tax result that could, and often would, be achieved today simply by carrying out the acquisition not as an asset acquisition but as a stock acquisition, as a purchase of stock without any 338 election or liquidation. I don't think that's a big substantive difference because I don't read Sam's proposals as altering the treatment of a simple purchase of stock. And what the Senate Finance Committee proposals would say in this respect is if it is more convenient as a matter of corporate procedure to make the transaction an asset acquisition rather than a stock acquisition (including a reverse subsidiary cash purchase or forced purchase transaction), there is no particular reason not to let the parties have the tax treatment determined independently of the choice of form for the transaction.

The other point of difference, I think, is the case in which there are three equal stockholders of a corporation who determine that the corporation should be transferred to a large acquiring corporation, but one of those three stockholders would be willing to accept stock of the acquiring corporation, particularly if it could be done on a nonrecognition basis, while the other two shareholders would like to have cash. That's the other test of the continuity-of-interest notion, and on that one I am a little puzzled if Sam is willing to continue our present reorganization provisions in that context without any general relative size limitation. That is, if even a very small corporation can be sold out to a large corporation for stock on a nonrecognition basis at the shareholder level, I don't see much reason for saying that that can only be done where a majority, or 80%, or wherever one might put the line, of the stockholders of the acquired corporation make that choice because, of course, the ones who don't are going to be taxed anyway; therefore, I think the Senate Finance Committee proposals are right on that difference as

well.

GINSBURG: I like Bill's reference to the romance of things. I guess my enduring romance is with section 341, and I was personally depressed at the original notion that we were going to repeal the collapsible corporation provision. You cannot imagine with what joy I read the final version in the Green Book and found that we are really going to keep part of it after all. I have one kid who still has two years of college left and Lord knows how much graduate school.

I think it is an important perception, in dealing with everything we've talked about, to recall this great truth. In subchapter C, under present law you can do anything. It is just a question of how, it is not a question of whether. I'm reinforcing that view because I think Sam suggested four or five transactions which Lord knows are somewhat difficult to do under present law. I think I can do all five, and if I can do all five, Lord knows what you people can do. I am just a poor school teacher. I think that the recognition of the truth of the present system leads you to appreciate that what the Subchapter C proposals of the Staff really do is replace the current electivity of tax treatment, which is in the design of the transaction, by an explicit form of electivity. Now I know everybody gets nervous when they hear that because they remember section 338. The genius of section 338 was that we were going to substitute explicit electivity for the corporate mechanics of a stepped-up tax basis by liquidation. But of course 338 didn't work out perfectly. However, appreciate that the main reason for that, I think, is really the *General Utilities* problem (see it's all a big circle), the feeling that somehow or other we must have consistency of tax treatment between the various companies in the target group and so on. If you eliminate *General Utilities* as a viable concern in Subchapter C, as I take it most of us if not all of us happily would, it seems to me that you actually can simplify this thing. Without that, then I certainly do agree with the Staff that the entire project is at best a doubtful proposition. In any event, since the Staff would eliminate *General Utilities*, I am all for it.

WOLFMAN: This business of love and romance. . . . I was delighted when Sam was a student studying corporate tax, I could see that he was falling in love. But I thought, and I was wrong, that he was falling in love with the *puzzle*, with working out within it and then considering whether the puzzle had to be. But he fell in love

with the *outcomes*. What's even more interesting is that most people, I think, who are in love, remain in love, but their passions abide after a time. His grows, and that's just extraordinary. I mean he doesn't accuse the Staff of just wanting to repeal sections 311, 337 and 336 but to rip them out. Repeal is a good word, it has been used before. That's all they want to do.

And sure, how can you live without having Mrs. Gregory's case? But you imply by the fact that we won't need a *Gregory* doctrine that the Staff report somehow or other would change the result in *Gregory*. You don't really believe that. Mrs. Gregory has got a dividend. Moreover, if the Staff report were adopted, the corporation would also be taxed because of the repeal of *General Utilities*. So the outcome is preserved and the result made even more rational. But you don't need to base it on something called a business-purpose doctrine, which just enables people like Marty to utilize and to create and to achieve anything he wants, whereas people who are less sophisticated can't achieve proper outcomes.

GINSBURG: I learned it all from you.

WOLFMAN: To get a little bit more specific, I'm delighted to see that Sam has moved to the point of thinking that *General Utilities* ought to go except in the case of goodwill, and I agree with that. As to land, Sam, there was a time when the ALI proposal also suggested that there be an exception for land, and the reason that land and goodwill were identified together was that the basis in land doesn't affect the computation of on-going income of the corporation. You can't depreciate it, either. The exception was dropped as to land because it was observed that in many instances a lot of current expense items that offset ordinary income are in fact some of the reasons that land values appreciate. Because of that problem, the land exception was dropped, although it is certainly arguable, and I can see you making that identity. But I must say I don't understand where buildings come into it at all, because the acquiror of the building is going to have a stepped-up basis and be able to depreciate it. And just because the building is on the land, the relationship with goodwill is nonexistent. Land and buildings in terms of this context are wholly different items.

With regard to the continuity-of-interest doctrine, Sam's paper elaborates his view of why the *Kass* case is correct, and I guess everybody else on the panel, perhaps save only Cym Lowell, thinks that the *Kass* case is a wonderful example of a wrong result, where

a woman was taxed because she took stock in a surviving entity in exchange for her own stock, while the overwhelming bulk of her co-shareholders, some 85-86%, took cash, and so she was taxed because there was insufficient continuity. And Sam accepts the language of the Tax Court rationale which says, "Why are we worrying about poor Mrs. Kass? After all, she could have sold her stock. She could have gotten cash." Well, I guess if the stock exchange hadn't closed by this time I could have called up my broker and sold all the stocks that I had at a gain today. But I didn't, and therefore I should be taxed if Mrs. Kass should be taxed. The point is she didn't sell her stock, she continued her interest. And I think you might also observe that if the merger had gone the other way, so that she hadn't technically realized the gain, but had kept her other stock, then she would be in exactly the same position as I am sitting here, and you wouldn't have said that just because she could call her broker she should be taxed. The continuity-of-interest rule has the perverse effect of saying that an individual who wants to continue his interest in the enterprise, not necessarily the entity, but in the enterprise, is going to be taxed only because not enough of his fellow shareholders feel the same way. I don't think that makes any sense. And that's the reason that the continuity-of-interest doctrine by so many of us has long outlived its usefulness. I suggest that the Finance Committee proposals give us an opportunity for a really sensible statute, one that does have neutrality, one that does not permit tax-free corporate step-ups in some circumstances and not in others. It provides for an objectivity and a simplification that I think is real. I don't think it is just the use of the word simplification. And it does indeed suggest that Marty may have to go to work, if it is enacted, to put the kids through college.

LOWELL: Sam, as I think about it, is unfortunate today because there are probably six people on the podium who disagree with him. I'm probably even less fortunate because probably everybody disagrees with me on what I'll have to say.

I'd like to make two comments with respect to what Sam and the others have had to say this afternoon. The first concerns the process of reform. I do not share the enthusiasm for reform of my colleagues, and instructive to me are three related things. One relates to the structure of the current statute, two relates to the ability to manipulate clear new rules, and the third relates to the pro-

pensity of reform to create unforeseen practical problems. We have already talked about each one of these items at other points in the discussion, but I would like to put them all together.

First, in terms of the structure of the current statute, I think we all agree that there is a crazy quilt of common law doctrines, statutory rules, statutory exceptions, regulations and what not. I find it instructive to go back to the original version of Subchapter C, now some 60 years old, and think about it. That statute composes a few basic paragraphs dealing with corporate reorganizations. Much of the complexity and detail of the current scheme, of course, has evolved as courts, regulators, and the Congress have dealt with the difficulties posed by ingenious school teachers like Marty in coming up with all forms of new transactions that seem to achieve results not intended by the basic statutory scheme.

In this connection, the Senate Finance Committee report confidently states that its proposals will eliminate much of the uncertainty of current law, and rationalize the crazy quilt of merger and acquisition rules, in eliminating the vague judicial glosses as to which Sam and my colleagues have expressed their views. I am sure that if the Finance Committee proposals were enacted, it will doubtlessly be true at the time of enactment that we will have a nice clean statute devoid, in theory at least, of common law doctrines. But, of course, poor school teachers like Marty will have to go back to work to support their children in college and will quickly start figuring out all sorts of ways of doing things that had not been intended under these statutory provisions that started out so nice and clean in 1985 or '86. And in due course, the courts, the regulators, and Congress will have to deal with that and will simply start the process anew. So it strikes me that all we do every few years is start this process again, and the most that I think we can hope to accomplish is to have a new slate upon which we will get rid of the old uncertainties but quickly will begin with a lot of new uncertainties. I, at least, prefer the old uncertainties to the new uncertainties, especially if, as Marty tells me, in the existing statute we can literally do anything we want if we simply structure the transaction appropriately. I find myself hard pressed to find a great deal of practical benefit in starting anew.

A second point relates to manipulation. I've not been in practice as long as my esteemed colleagues, but I have been impressed, when new rules come up, with the ease with which creative minds

undertake to turn those rules back on whoever came up with them to achieve things that the creator of the rules did not have in mind. One example of this process in the Subchapter C area is the ill-fated section 385 regulations. In those regulations, there were a number of safe harbor, objective rules that would be easy to apply and would solve all the problems of current debt/equity classification. One part of those provisions was the rules dealing with hybrid instruments, which provided that if equity-like characteristics met only a certain percentage of the value of the instruments, then the instrument would either be treated as debt or equity, as the case may be, depending on which side of the percentage line it fell. The tax bar, of course, quickly adapted to these rules and came up with a number of forms of instrument which, given the rules, would be treated as debt or as equity, depending on what the taxpayer desired. This led the Treasury ultimately to withdraw the regulations and simply not to go forward with the process. I think we must assume that the new rules we come up with now, if these Staff proposals are enacted, will have the same kind of experience in the future.

And the third is simply to note how unintended practical problems are inevitably caused by lovely new statutory provisions. An illustration is our most recent experience with section 338, on which Marty has already commented.

What I would draw from these observations about the nature of reform is that I would agree with Sam that if we are going to have change, and I think we all agree that change is in order to try to rectify as much of the crazy quilt as possible, we should modify the statute in the least extensive manner possible, and avoid a wholesale revision unless it is simply not possible to implement the changes necessary in the existing statute.

The final point I will make in terms of the proposals concerns the *General Utilities* doctrine. This is a conference for Eddie Cohen, I've agreed with Eddie Cohen in this area in the past, and I would not carry out my duties if I didn't observe that it seems fundamentally unfair to repeal the *General Utilities* doctrine at the current time. We prepared a report published in the *Tax Lawyer* a couple of years ago noting the basic reasons for approving repeal [37 *Tax Law*. 638-40 (1984)], and I don't think we really have time now to go through those, except to say that in the Finance Committee report, repeal of the *General Utilities* doctrine is

identified as being a logical necessity, but I believe that such a step would be the single clearest aberration from current law. In the Subchapter C reforms of the Green Book, the structure of the statute is altered but without significant change to underlying results to taxpayers, with the exception of the repeal of *General Utilities*. This repeal would, in effect, impose an increase from a 20% to a 42.4% tax on liquidation of corporations, and to me this is fundamentally unfair. To justify it under the guise of "this must be repealed in order to carry out the logic of the changes we want to make" sort of begs the question. We always have aberrations, Sam points out, exceptions on exceptions, and it may be that this is simply an exception that needs to remain in the statute. I would also point out that if the Finance Committee proposals were enacted, the shareholder-flavoring and consistency rules also strike me as being inconsistent with the overall intent to create a neutral, relatively straightforward statute. I don't want Marty to have to deal with the shareholder-flavoring rules in order to finance the education of his children.

THOMPSON: I would like to make two points. First, on repeal of *General Utilities*. There is no tax under these proposals unless the parties make a cost basis election. In my judgment, from the transactions that I see in Chicago, no target company is going to make a cost basis election because the detriment associated with the immediate tax payment is not going to be offset by the increased tax deductions that the acquiring company is going to receive. As a consequence, I think if these proposals are enacted we will have nothing but carryover basis acquisitions.

Second, assuming we are going to do away with the continuity-of-interest doctrine as Bernie suggests, why do we come out by saying Mrs. Kass therefore gets tax-free treatment when she receives stock of an acquiring company? Why don't we say she gets taxable treatment, just as I would get taxable treatment if I swapped my stock in General Motors for stock in IBM? Why do we tilt in the direction of a rule of nonrecognition?

DeARMENT: One involved an acquisition and one didn't.

THOMPSON: Once you do away with the continuity-of-interest doctrine, what is so unique about an acquisition transaction that should give rise to tax-free treatment to a shareholder who swaps stock for stock?