St. John's Law Review

Volume 44
Number 5 *Volume 44, Spring 1970, Special Edition*

Article 78

December 2012

The Tax Legislation Against Conglomerates--The Case Against the Tax Legislation

George H. Jewell Jr.

Follow this and additional works at: https://scholarship.law.stjohns.edu/lawreview

Recommended Citation

Jewell, George H. Jr. (1970) "The Tax Legislation Against Conglomerates--The Case Against the Tax Legislation," *St. John's Law Review*: Vol. 44 : No. 5 , Article 78.
Available at: https://scholarship.law.stjohns.edu/lawreview/vol44/iss5/78

This Symposium is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact selbyc@stjohns.edu.

THE TAX LEGISLATION AGAINST CONGLOMERATES — THE CASE AGAINST THE TAX LEGISLATION

GEORGE H. JEWELL, JR.*

With the coming of Spring 1969, the bears emerged snarling on Wall Street and a great many people took severe beatings in the stock market. Somewhere a scapegoat had to be found; nominated without opposition and elected by acclamation was that one time darling of the investment community — the conglomerate. Once the culprit was located, no form of punishment was too severe. Stick pins in his image; burn crosses on his lawn; apply a bamboo shoot or two under his fingernails; and — most sadistic of all — roast him upon the spit of federal income tax "reform."

The object of this article is to analyze the federal income tax movement against conglomerates — to trace its conception, birth and development; to comment upon the validity of such an approach from a social and economic vantage; and finally to note that the lawmakers have burdened what is already the most complicated revenue raising system the world has ever known with further complexities which cannot, because of the very nature of our system, accomplish their goal. Considering the latter, the Internal Revenue Code must apply equally to all corporations having similar form and conducting similar business. There is no acceptable way to deny a particular tax treatment to an organization labeled "conglomerate" without also denying it to other organizations not wearing such an opprobrious label. Nothing in the legislation has particular applicability to conglomerates; perhaps such discriminatory legislation would be unconstitutional anyway. It is simply time to stop brandishing this legislation as anti-conglomerate.

What we are really talking about, then, is the so-called take-over phenomenon. We are not talking about conglomerates at all, except that some of the more notable take-overs have been consummated by conglomerates. On the other hand, some very notable acquisitions have also been engineered by nonconglomerates. The point is that until recently antitrust forces did not move against conglomerate acquisitions, but did against congeneric ones. To fill this gap, the House Ways and Means Committee set about attempting to supply some kind of take-over prohibition in the form of tax legislation.

The Tax Reform Act of 1969 contains four principal provisions affecting corporate acquisitions: section 411 of the Act adds new section 279 to the Internal Revenue Code of 1954, denying an interest deduction in certain cases;[1] section 412 of the Act amends Code section 453(b) to deny installment

* Member of the Texas Bar. B.A., The University of Texas, 1942; LL.B., The University of Texas, 1950.

[1] I.R.C. § 279 (new).

reporting where certain types of debt instruments are received in a sale;[2] sections 413[3] and 414[4] of the Act have to do with original issue discount and convertible indebtedness repurchase premium. The first two of these will be examined in detail.

LEGISLATIVE HISTORY

The first hint that the corporate take-over was under tax siege was on January 29, 1969, when the House Ways and Means Committee announced that public hearings on tax reform were to commence on February 18. One of the topics for consideration was "the tax treatment of bonds and debentures received for stock in a merger."[5] Of course, this could have meant almost anything; the use of the word "received," however, led one to conclude that the tax treatment of the recipient was that being considered. Installment reporting was the likely target (and apparently the only target at that early date) since there had been indications that the Internal Revenue Service was considering adopting the view that securities which circulate in the market place should be treated like cash and taxed when received rather than when sold or collected. Corporate tax counsel, however, were almost uniformly of the view that any such position would have been based more on prejudice than sound legal position. Consequently, the prospecti attending a number of major corporate acquisitions contained advice that counsel was of the opinion that the recipient of the debt securities was entitled to treat the securities as "evidences of indebtedness" within the meaning of section 453. Thus, installment reporting was permitted if other requirements were met.[6]

Sometime in February 1969, Chairman Wilbur Mills of the Ways and Means Committee became more interested in anti-take-over legislation. It has been suggested that it was about this time that he was visited by the general counsel of B. F. Goodrich Company, which was then the subject of a take-over effort by Northwest Industries.[7] On February 10, Chairman Mills announced that the study of debentures received for stock would include the interest deduction of the issuer, as well as installment reporting.[8]

On February 24, while the hearings were barely starting, Chairman Mills introduced H.R. 7489.[9] This bill, clearly "anti-raider" and little more,

---

[2] *Id.* § 453(b) (amend).

[3] *Id.* §§ 1232(a), (b)(2) & 6049(c) (amend).

[4] *Id.* § 249 (new).

[5] Committee on Ways and Means, U.S. House of Representatives, Press Release No. 2 (Jan. 29, 1969).

[6] *See* Berger & Kanter, *Installment Reporting on Receipt of Bonds in Corporate Acquisition*, 30 J. TAXATION 198 (1969).

[7] O'Hanlon, *Goodrich's Four-Ply Defense*, FORTUNE, July 1969, at 110, 113.

[8] Wall Street Journal, Feb. 11, 1969, at 4, col. 2.

[9] H.R. 7489, 91st Cong., 1st Sess. (1969). H.R. 7489 would have provided, in pertinent part, that

If, pursuant to a plan —

(1) one corporation acquires stock of another corporation, and

(2) more than 35 percent of the consideration for the stock so acquired con-

proposed that if a corporation acquired stock of another corporation and over 35 percent of the consideration for the stock so acquired consisted of debt or property attributable to borrowing, a part of the interest deduction on this debt would be forfeited. The recipient would not be entitled to use the installment method of reporting if he received bonds or debentures in registered form or with coupons attached.

H.R. 7489 was obviously directed at the hostile take-over, as distinguished from the friendly one. Otherwise, why did the measure penalize only the acquisition of *stock*, and not the acquisition of assets or the merger transaction? The reason is quite simple. To effect an asset acquisition or a merger, the management of the company to be acquired must cooperate. The only kind of take-over which can be used where management is unfriendly is the stock acquisition, usually pursuant to a tender offer. A tax provision based upon such a narrow distinction, with predominately private rather than public purposes, has little to recommend it.

The next public pronouncements in this area came from the administration. President Nixon's message of April 21 was silent on this point,[10] but Assistant Secretary of the Treasury Cohen's statement to the Ways and Means Committee on April 22 indicated that the legislation proposed as an interim program for 1969 would deal with "the tax problems of certain corporate securities frequently associated with corporate acquisitions."[11] Secretary Cohen stated that the interest deduction was not the primary motivation in debt acquisitions, and even if it were, the correct treatment would be to deny the interest deduction only if the underlying obligation were really equity rather than debt. On a broader scale, Secretary Cohen said that the administration was interested in making a complete study of the tax-free reorganization phenomenon to determine whether the present tax laws offer a special inducement to combinations. The only measures intended for immediate passage were: (1) to deny installment reporting for debt in registered form or with coupons attached; (2) to require accrual and current reporting of bond discount; and (3) to disallow the deduction of the part of bond repurchase premium attributable to a conversion feature.

> sisted of evidence of indebtedness of the acquiring corporation or of other property attributable to borrowing by the acquiring corporation, then the amount which (but for this section) would be allowable to the acquiring corporation or to any other person as a deduction for any taxable year for interest paid or accrued with respect to such evidences of indebtedness or other borrowing (or with respect to any refinancing thereof) shall be reduced to the amount obtained by multiplying the amount of such interest by a fraction the numerator of which is 35 percent and the denominator of which is the percentage arrived at under paragraph (2).

The installment reporting change would have added to section 453(b), INT. REV. CODE of 1954, a new paragraph reading

> (3) RULE FOR APPLYING PARAGRAPH (2).—A bond or debenture issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form, shall not be treated as an evidence of indebtedness of the purchaser for purposes of paragraph (2) of this subsection.

10 HOUSE COMM. ON WAYS AND MEANS, 91ST CONG., 1ST SESS., MESSAGE FROM THE PRESIDENT OF THE UNITED STATES REGARDING TAX REFORM 1-4 (Comm. Print 1969).

11 *Id.* at 46, 73, 183.

The Treasury approach thus recognized and validated the existing framework and would have worked within it, along traditional lines. It at once verified that an interest deduction is proper if the underlying security is debt, and denied the validity of an attempt to differentiate between types of debt. The strongest memory of a distinction between types of debt comes from section 265,[12] which denies the interest deduction on indebtedness incurred or continued, to purchase or carry tax-exempt securities. The section has produced an administrative nightmare, with many still unresolved questions remaining. However, if section 265 is necessary at all, the necessity for it is at least of tax origin, which justifies it as a tax measure. A tax provision which would allow deduction of interest on some debts but deny it on identical debts because issued in acquisitions is of antitrust or entrenched management origin and has no justification as a tax measure.

During the Ways and Means Committee hearings, however, the Treasury approach got lost. Contrary to the Treasury recommendations, the Committee adopted, and the House passed, a bill directed at the interest deduction. The House Bill denied a deduction for interest in excess of $5 million per year in the case of bonds or debentures issued by a corporation to acquire stock in another corporation or to acquire at least two-thirds of the assets of another corporation. The rule would apply, however, only in the case of debt which is subordinated to the corporation's trade creditors, is convertible into stock, and is issued by a corporation with a debt-equity ratio greater than two-to-one, or with annual interest expense not covered at least three times by projected earnings.[13] Intricate rules are established for determining projected earnings.[14]

The House Bill reflected the emergence of a general antipathy to corporate acquisitions of a taxable nature. It matters not under the House Bill whether the acquisition is by way of a hostile take-over or not, for the acquisition would fall within the provisions of the House Bill even though it be by way of merger or asset acquisition, both of which require the cooperation of management.

The Treasury's position that the true rule for disallowance of interest should be based upon whether the underlying security is debt or equity apparently served as the basis for the tests imposed, *i.e.*, subordination, convertibility, and high debt-equity ratio. The tests are relevant to the question of whether the underlying security is debt or equity, based upon whether the funds thus entrusted to the corporation are truly intended to be repaid, or whether they are put at the risk of the business, as, for example, by way of a second class of stock. Except for the lack of comprehensiveness, tax theorists could have no quarrel with this general approach. The details, however, are subject to a great deal of dispute, for example, whether a two-to-one debt-equity ratio or a three times interest expense earnings

[12] I.R.C. § 265.
[13] House Version § 411.
[14] *Id.*

coverage is anything more than a punitive approach to the question. The basic fallacy of the approach, however, from a theoretical tax standpoint, is that the interest deduction is denied where these tests are met in the case of bonds or debentures issued in a corporate acquisition, but is permitted where the same bonds or debentures are issued for general corporate purposes.

INTEREST DEDUCTION

Consider the complexities which such a measure generates. Under section 279(c)(2) a determination is made as of the last day of the taxable year of the issuing corporation in which it issues an obligation to provide consideration for an acquisition as to whether the obligation constitutes "corporate acquisition indebtedness." If the indebtedness is determined to be corporate acquisition indebtedness because it was issued to provide consideration for the acquisition of stock or assets of another corporation, if it is subordinated to the claims of trade creditors, and if it is either convertible or part of an investment unit including a warrant, this indebtedness remains corporate acquisition indebtedness as long as it is outstanding. Presumably, the regulations issued pursuant to this section will provide that indebtedness which is created to provide funds with which to refund or satisfy corporate acquisition indebtedness is itself corporate acquisition indebtedness. Thus, a very difficult problem of tracing will be created, with the result being in many cases that the interest on a portion of future created indebtedness will be non-deductible under section 279, but the balance of such interest will not be tainted. What if corporate acquisition indebtedness is satisfied out of general funds of the corporation, but in the year of satisfaction the corporation issues several new debt securities bearing differing rates of interest? Which of these is the replacement indebtedness and what interest is to be disallowed as a deduction? What would be the rule where one corporation acquires a portion of the assets of another corporation for debt securities having a face amount of, say, $2 million, there being no determination at the time of the value of the remaining assets of the corporation? Query, whether two-thirds of the assets have been acquired?

Financial reporting requirements for SEC purposes will undoubtedly require a disclosure of whether the interest expense on a particular debt is deductible for federal income tax purposes. At least, it would seem that a person investigating a corporation with the prospect of acquiring some of its stock is entitled to know whether the securities of the corporation are regular in all respects, including the deductibility of interest paid thereon, or whether they are of a hybrid type, the interest on which is not deductible. Thus, another difficult problem will arise in close cases of making an advance determination of whether a particular item of indebtedness is corporate acquisition indebtedness or not.

The debt-equity ratio test must be satisfied as of the last day of the

taxable year in which the corporation issues the debt securities. Unless the acquisition is made late in the year, it will be virtually impossible to plan, in close cases, for meeting the required ratio at the end of the year. The projected earnings test does not involve a projection of earnings at all. Projected earnings are defined by the statute to mean earnings for the three years ending with the last day of the year in which the acquisition is made. On the other hand, the interest costs to be compared with "projected earnings" include interest to be paid on the new securities. Thus, one is comparing apples and oranges. The three-year period prior to the last day of the year in which the acquisition is made would seem to have no particular relevance to earnings of the corporation which can be expected subsequent to the acquisition, during which time the interest in question is going to be paid.

To add further complexity to confusion already compounded, even though the debt-equity test and projected earnings tests are met in the year in which an initial stock acquisition is made, if, in a subsequent year, more stock is acquired, the tests must be met anew as of the last day of that subsequent year or all indebtedness will have its interest deduction disallowed, including interest on both the indebtedness issued in the subsequent year, perhaps to acquire only a small amount of additional stock, as well as interest on the indebtedness incurred in connection with the initial acquisition.

The Senate Finance Committee[15] basically adopted the provisions of the House Bill, although attempting to relax them somewhat.[16] The Finance Committee would have changed the debt-equity ratio to four-to-one and the interest coverage requirement to two times, rather than three times. The Bill as finally passed, however, reverted to the House version. One Senate change which did stick makes it possible to pass the tests later if not passed at first. Thus, even though the interest deduction is disallowed because the debt-equity test or the earnings test was not met in the year of issuance, the interest may later become deductible if both of these tests are met for a period of at least three years.[17]

The tax purpose most frequently recited is that the legislation will avoid a loss of tax revenues because dividend paying stock is being replaced by debt. The interest on debt is deductible by the payor, but dividends on stock are not. The non-tax purpose most often heard is that the provisions of the Internal Revenue Code should not be oriented so as to encourage conglomerate acquisitions. The first of these purposes, the tax purpose, would appear fallacious. The traditional reason for permitting the deduction of interest is that the cost of capital is truly an expense of the business, just as much as the cost of raw materials, and to preclude its

---

15 *See* Senate Version.

16 *Id.* § 411.

17 Tax Reform Act § 411, I.R.C. § 279.

deduction would militate in the direction of a tax on gross income, a concept never accepted in the United States. On the other hand, dividends paid to the stockholders of a business represent merely a division of the profits, as contrasted with an expense of doing business. Hence, dividends have never been, and should not be, deductible by the payor corporation. Working within this well-settled framework, there is little basis for an argument that a transformation of a part of a corporation's capital stock into debt, if that transformation is truly made, should require a change in basic taxing concepts just to avoid a loss of revenues. One could easily argue that the only basis for such a position would be that the government must have some kind of vested right, once corporate stock is outstanding, in requiring it to remain outstanding. Further fallacies with this argument also exist. What of the acquisition of a corporation by the use of debt securities where the acquired corporation has never paid dividends on its stock? What if the corporation has no accumulated earnings and could not pay dividends even if it wanted to?

What is overlooked is that the federal income tax authorities from antiquity have fashioned a very carefully reasoned framework of case law, regulations and rulings, differentiating between debt and equity, permitting an interest deduction in the one case and preventing a dividend deduction in the other. These debt versus equity rules apply whether or not an "acquisition" is involved. Interest has always been a legitimate deduction and it should have been left that way. If mergers through the use of debt securities are bad from a social or economic standpoint, they should be dealt with under the antitrust laws by the Justice Department or the Federal Trade Commission. If the antitrust laws are not adequate to take care of the cases which are concerning the Congress, it is the antitrust laws which should be changed, and not the tax laws. What started out as a simple little bill to save entrenched management has turned into a monster which adds at least three additional pages to an already bulging Internal Revenue Code, pages which will have to be read and reread and explained by lawyers and accountants to bewildered executives forever more. In effect this legislation diverts us from the task at hand, namely, to devise a revenue system which will operate fairly and equitably for all, will raise an appropriate amount of money, and, of particular significance, will have a bland or neutral effect upon business forms and transactions. Starting from where we are, this is impossible, of course, but if a proposed tax measure clearly works contra to these goals, it is bad legislation.

INSTALLMENT REPORTING

The installment reporting provisions are easier to understand.[18] While the House version contained a provision that to qualify for installment reporting generally, payments received in the future would have to be

[18] Tax Reform Act § 412, I.R.C. § 453(b).

spread relatively evenly over the period of payment, this was removed by the Senate Finance Committee, and the final bill does not contain such a provision. The basic provision is to the effect that a bond or other evidence of indebtedness issued by a corporation or a government or political subdivision thereof with interest coupons attached, in registered form, or in any other form designed to render such bond or other evidence of indebtedness readily tradable on an established securities market, shall not be treated as an evidence of indebtedness qualifying for installment reporting under section 453.

While it violates the purpose and intended spirit with which the installment reporting provisions were passed originally, there is no basic objection to this amendment from a tax theory standpoint. What the Congress giveth, it can take away. Without section 453, all obligations of a purchaser would have to be valued in the year of receipt and reported as income at that time. Amounts ultimately collected in excess of such value would be taxable at ordinary rates. If incapable of evaluation, deferral of reporting would be possible until collection. The thing which has troubled the Treasury Department and the Internal Revenue Service through the years is that bonds or debentures issued to many persons at the same time in connection with the acquisition of stock or assets of a corporation bear at best only a slight resemblance to the acquisition of the corner drug store for an installment note payable $100 per month for 5 years.

Analyzed, however, there is no difference. A taxpayer has sold an asset, and has not yet received his money for it. The Treasury has argued, yes, this is true, but he could get his money at any time he wants it because the bond or debenture he receives is readily marketable. The answer to this is that the law already makes provision for this, because when a taxpayer does utilize this right and does receive his money upon marketing the bond or debenture, he pays a tax at that time.

Again, the question of whether bonds or debentures of this nature have been used to make corporate acquisitions which are anti-social, or which have bad economic effects, should indeed be immaterial to the administration of the tax laws. These matters should be policed by the antitrust authorities who presumably can distinguish between good and bad mergers and can prevent the bad ones from being consummated. There is no way for the tax laws to do this. The revenue system is a woefully ineffective and inadequate antitrust policing device.