Tax Reform and Corporate Acquisitions

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INTRODUCTION

Most of the rhetoric about tax reform proposals (generically, if inaccurately, referred to as "flat tax" proposals) has focused on the effect of the proposals on economic growth and, secondarily, on simplification of the tax laws. A politically potent undertone, emphasized by aspiring politicians, has been the suggestion that the proposals would lead to lower tax burdens. The number seventeen percent has been floated about and a seventeen percent rate sounds very tempting if your current federal tax rate is 39.6 percent or higher. Little attention has been paid, however, to the effect of tax reform proposals on different types of transactions or forms of conduct. In this Article, I will explore the effect of two types of tax reform proposals on purchases and sales of corporate businesses. The Article will not discuss the purchase or sale of an unincorporated business. It will be confined to transactions that now involve legal entities that, with their owners, are subject to a double tax at the entity and owner levels under our present, substantially unintegrated tax system.

This Article will focus on the Nunn-Domenici bill, which the authors have patriotically named the Unlimited Savings Allowance Income Tax System, or "USA" tax.[1] By way of contrast, the Article will examine Representative Armey's "flat tax" proposal.[2] The Article will not

1. S. 722, 104th Cong. § 1(a) (1995).

2. H.R. 2060, 104th Cong. (1995); S.1050, 104th Cong. (1995). The Act's rather cumbersome formal title—the "Freedom and Fairness Restoration Act of 1995"—will not be used in this Article.

address value-added taxes, which are more like retail sales taxes imposed only at the business entity level and do not involve a current tax on individuals (except to the extent that individuals pay the final tax at the last step of the distribution chain).

Analyzing the approaches in these bills is complicated by the fact that the USA tax has been incorporated in a detailed bill with an even more detailed explanation, whereas the Armey tax has not been well developed. Although a bill incorporating the Armey tax has been drafted, it is primitive in form and would have to be fleshed out before being enacted. I will offer some suggestions in the course of the analysis as to how the cracks might be filled in.

The USA tax is, in essence, a consumption tax. Although its language speaks in terms of an income tax with a deduction for savings, the savings deduction effectively converts it to a tax on income that is spent and not saved or invested. The Armey tax, in contrast, is not a consumption tax. The amount of savings is irrelevant. It is a tax on income with an exclusion for investment income.

In either case, the concept of gains on the sale of investment assets becomes, at the shareholder level at least, irrelevant. Under the Armey tax, gains on the sale of investment assets at the individual level are excluded from the tax base. Under the USA tax, proceeds from the sale of property are theoretically taxed, but not if they are reinvested in savings assets. The result is that under either regime the impact of the tax system on business acquisitions will be considerably less dramatic (and traumatic) than it is under present law.

I will not in this Article discuss the transitional problems that would be presented in shifting from an income tax to a consumption tax or flat income tax. The Article's purpose is to explore the ways in which the proposed new tax systems would operate in a fully implemented form. In fact, the transitional problems in shifting to a new regime would be formidable. Assets that, in a pure new system, would have a zero basis, may, if carried over from the present system, have a transitional basis that would complicate tax planning. The transitional problems present basic issues of fairness and, if addressed thoughtfully, could result in enough complexity to get the present generation of tax lawyers safely through to retirement and could support the next generation for years to come.

THE USA TAX[3]

The USA tax, as indicated above, is a consumption tax, not an income tax, although the calculation begins with a determination of income. Perhaps a better characterization would be that it is a consumed income tax, because it is imposed on income that is spent and not saved.

Under the USA tax, businesses, whether corporations or unincorporated entities or sole proprietorships, pay tax on their annual gross profits from business conducted in the United States.[4] Although this Article will focus on corporations, many of the principles apply to unincorporated businesses as well.

A corporation can deduct business expenses under the USA tax, including the cost of purchases of capital assets and other property.[5] The ability to deduct capital expenses under the USA tax means that a corporation's economic income is likely to be deferred and taxed only in years after it would be regarded as being realized under the accounting principles that are normally applied in determining a corporation's income. The cost of property is deducted at once, even though the income that it generates will only be taxed over the property's productive life. Thus, under the USA tax, a corporation that is expanding and is buying new plants and equipment may have business purchases that exceed its taxable receipts even though it is making net income under income accounting principles. This may sound odd unless one remembers that the USA tax is a consumption tax, not an income tax, so that traditional concepts of measuring income, like Gilbert and Sullivan's "flowers that bloom in the spring," have nothing to do with the case. The excess of expenses over taxable receipts is a loss that cannot be carried back for a refund but can be carried forward for fifteen years.[6] The loss carryover of an expanding business that is incurring capital expenses may be an attractive asset for potential purchasers of the corporation's stock.

Under the USA tax, the gross income of an individual includes "distributions from business entities" representing compensation for the

3. *See supra* note 1.
4. S. 722, § 101(b)(3).
5. S. 722, § 204(a)(1).
6. S. 722, § 207(b).

use of capital, including interest, dividends, or a return of capital.[7] Thus, not only are dividends included in the tax base, but so are distributions from corporations that lack earnings and profits and that under present law would be treated as tax-free returns of capital.[8]

Although the inclusion of all distributions from corporations in the individual tax base would, at first blush, appear to be harsher than the comparable treatment under the present tax system, Messrs. Nunn and Domenici have provided a benefit that more than compensates for this apparent disadvantage. The centerpiece of their system is the "unlimited savings allowance," or the deduction for income that is saved and not consumed. Additions to savings that, in effect, are deductible, include the acquisition of "stocks, bonds, securities, certificates of deposit[s], investments in partnerships and proprietorships, shares of mutual funds, life insurance policies, annuities, and other similar saving or investment assets."[9] Thus, an individual taxpayer, including a shareholder of a corporation, has an unlimited ability to avoid tax on his or her income by placing that income in an approved savings vehicle. Another way of looking at this is that the amount of an individual's income that will be subject to tax in this brave new world is a function of the amount of income that he or she needs to spend on life's necessities and cares to spend on life's pleasures. It is obvious that poor people, who may have to spend substantially all of their income on food, clothing, and other necessaries, are likely to pay a higher proportion of their income in tax than are rich people, who are likely to have income in excess of their needs and who will be in a position to save much of it.

Under the USA tax, certain items are specifically excluded from savings assets. They include land (including investments in business entities whose primary purpose is investment in land), cash, collectibles, and business entities the purpose of which is to hold collectibles for appreciation.[10]

A withdrawal from savings that reduces the taxpayer's unlimited savings allowance, including proceeds from the sale, exchange, or other disposition of a savings asset, is included in the tax base.[11] This includes the proceeds from the sale or exchange of stock of a corporation or an interest in an unincorporated business. Since the cost of the stock that is sold will have been deducted (as an addition to the taxpayer's savings allowance), the shareholder will typically have, in

7. S.722, § 3(a)(3); I.R.C. § 201, subch. A (1996).
8. I.R.C. § 301(c) (1996).
9. S. 722, § 53(b); I.R.C. § 201, subch. B.
10. S. 722, § 53(c).
11. S. 722, § 54(a)(1).

today's language, a zero basis for the stock. Hence, the gross receipts from the sale of a corporation's stock are treated as a withdrawal from savings and are added to the base that is subject to tax.

The mechanism for taxing sales of savings assets, including stock in corporations, under the USA tax is somewhat convoluted. The sale, exchange, or other disposition of a savings asset constitutes a "withdrawal."[12] To the extent that the withdrawal exceeds the basis of the savings withdrawn, it is a "taxable withdrawal."[13] Taxable withdrawals reduce the taxpayer's "net savings" and, hence, reduce the deductible net savings and the unlimited savings allowance.[14] Since the unlimited savings allowance reduces the taxpayer's adjusted gross income and taxable income, this produces a tax.[15]

If the taxable withdrawals exceed the additions to savings for a taxable year, the excess is a "net withdrawal."[16] The excess of net withdrawals over the basis of the taxpayer's assets is "net includable withdrawal income."[17] The taxpayer's net includable withdrawal income becomes the taxpayer's "deferred income" for the taxable year.[18] The taxpayer's adjusted gross income includes his or her current-year gross income and deferred income.[19]

Loan proceeds are not included in an individual's income under the USA tax.[20] This obviously could open a huge loophole by enabling taxpayers to borrow money in order to make deductible investments in savings assets. Messrs. Nunn and Domenici are smart folks, and they have provided anti-abuse rules to prevent this type of manipulation. The bill provides that a taxpayer may not treat as a savings asset an asset acquired with funds borrowed for the purpose of increasing the unlimited savings allowance or decreasing deferred income.[21] Moreover, the Treasury can prescribe rules that treat debt secured by an interest in savings assets as an amount withdrawn from savings.[22] Implementing

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12. *Id.*
13. S. 722, § 54(b); I.R.C. § 201, subch. B.
14. S. 722, §§ 52(a)(1), 50(b).
15. S. 722, § 1(b)-(c); I.R.C. § 201, subch. A.
16. S. 722, § 52(b)(1)(A); I.R.C. § 201, subch. B.
17. S. 722, § 52(b)(2).
18. S. 722, § 51(b).
19. S. 722, § 1(c); I.R.C. § 201, subch. A.
20. S. 722, § 4(a)(7).
21. S. 722, § 58(a)(1); I.R.C. § 201, subch. B.
22. S. 722, § 58(c).

these provisions will obviously involve formidable tracing problems. As a further safeguard, the bill provides that deductible net savings in a given year is the excess of net savings over the sum of a number of items, including the increase in debt during the year (other than debt incurred to finance the purchase, construction, or renovation of the taxpayer's principal residence, debt to acquire consumer durables, and debt to purchase goods or services). A cushion of $10,000 of deductible debt for other purposes is also allowed.[23]

With this by way of general background, let us now examine the impact of the USA tax on corporate acquisitions and related transactions.

If a shareholder sells stock in a corporation for cash or property other than savings assets, the receipts from the sale are included in the tax base and, in effect, are taxable. The conversion of stock to cash is treated as a withdrawal from savings. On the other hand, a sale of stock in exchange for stock of another corporation will effectively be tax-free because it will amount to a trade of one savings asset for another savings asset. If the transaction were treated as a sale for cash followed by a reinvestment of the cash in stock of the acquiring corporation, the result would be the same because the receipt of income from the sale would be matched by a deduction for the reinvestment. In fact, under the USA tax, tax-free treatment would apply to the sale of an interest in a corporation for an interest in another business even if the other business were a partnership or another unincorporated entity, unlike present law in which a sale of stock by the shareholders of a corporation is tax-free only if, in general, the consideration received is stock of a purchasing corporation.[24] If a shareholder exchanges stock in a corporation for a combination of stock of an acquiring corporation and cash under the USA tax, the receipt of the stock of the acquiring corporation will be treated as a reinvestment in a savings asset, and the cash will be treated as a taxable withdrawal from savings.

The tax at the shareholder level will be determined on a shareholder-by-shareholder basis. Under present law, a sale of a corporate business in exchange for stock of an acquiring corporation will be a tax-free reorganization only if the overall transaction meets certain tests. If the transaction is a statutory merger of the target into an acquiring corporation, the transaction will be tax-free as to those target shareholders receiving stock only if a substantial portion of the consideration received by all target shareholders in the aggregate consists of stock of the acquiring corporation or its parent under the judicially-imposed

23. S. 722, § 55.
24. I.R.C. §§ 354-56, 368 (1996).

continuity of interest test.[25] If the shareholders of the target corporation exchange their stock in a non-merger transaction for stock of the acquiring corporation or its parent, the transaction will be tax-free as to target shareholders receiving stock only if the consideration in the entire transaction is solely voting stock and if the acquiring corporation receives eighty percent or more of the target's stock.[26] *The continuity of interest test must also be met.* If the transaction takes the form of a non-merger sale of assets by the target company in exchange for acquiring company stock followed by a liquidation of the target, tax-free treatment will be available to shareholders receiving acquiring company stock only if the target transfers substantially all of its assets and no more than twenty percent of the consideration received (reduced by assumed liabilities) is property other than voting stock of the acquiring corporation or its parent.[27] *The continuity of interest test must also be met.* If the transaction takes the form of a merger of a subsidiary of the acquiring corporation into the target, at least eighty percent of the target's stock must be acquired, no more than twenty-percent of the consideration can be cash or property other than voting stock of the subsidiary's parent, and the target must hold substantially all of its assets and those of the merged subsidiary after the transaction.[28] The continuity of interest test applies here as well. Thus, if a shareholder transfers stock of a corporation to another corporation in exchange for the acquiring corporation's stock, the transaction will not be tax-free unless it is part of an overall transaction that involves the acquisition of the target corporation or its business and consideration tests are met with respect to all of the target shareholders as a group. In contrast, under the USA tax an individual minority shareholder may transfer stock of a corporation to a buyer (individual or corporate) in a transaction of which the corporation and the other shareholders are wholly unaware and receive tax-free treatment if the amount received in exchange is stock of another corporation or another kind of savings asset.

If a corporation buys the stock of another corporation, there is no tax at the target corporation level under the USA tax.[29] The buyer gets no

25. C.F.R. § 1.368-1(b) (1996).
26. I.R.C. § 368(a)(1)(B), (c) (1996).
27. I.R.C. § 368(a)(1)(C), (a)(2)(B)(iii) (1996).
28. I.R.C. § 368(a)(2)(E), (c) (1996).
29. S. 722, 104th Cong. §203(e) (1995).

deduction, the target corporation has no income, and the target's loss carryovers and other tax attributes remain. This is true even if the target merges into the buyer. The net operating loss carryovers and other tax attributes carry over to the buyer.

Under the USA tax, the transfer of stock of a subsidiary or a closely-held corporation to a publicly-held corporation in exchange for freely tradeable sales of the public corporation's stock would be a tax-free financial transaction even though the nature of the seller's investment would be dramatically transformed from non-marketable stock in a closely-held business to stock that can be instantly converted into cash.[30] Tax is imposed only when that conversion occurs.

The USA business tax has special provisions relating to mergers of one business entity into another or consolidations of two or more business entities into a new entity. These transactions are tax-free, and the surviving entity assumes the tax attributes of the merged entities, including net operating loss carryovers.[31] The USA business tax refers to "mergers" without using the phrase "statutory merger." This may indicate an attempt to extend the provision to unincorporated entities where typically state laws do not prescribe merger procedures. It raises a question of whether a sale of assets of a corporation in a transaction that is not a statutory merger under state law, followed by a liquidation of that corporation that is treated as a tax-free reorganization under section 368(a)(1)(C) of present law,[32] will be treated as a "merger" under the USA business tax. Such transactions are often colloquially regarded as de facto mergers today.

Under the USA business tax, a sale of a business' assets for cash will generally be taxable,[33] although the portion of the price allocated to financial instruments will not be included in gross receipts and, hence, will not be taxed.[34] The taxable receipts will be reduced by any tax basis that the target company has in the assets sold that might remain from the pre-USA tax period.[35] A corporation may also have a basis in raw land that was not purchased for business use, the cost of which is not deductible under the USA business tax.[36] The statute contemplates that consistency as to the allocation of the sale price will be required as between the seller and the buyer. The rules of current Code

30. S. 722, § 203(e)(2)(C); I.R.C. § 302, subch. B (1996).
31. S. 722, § 213(a); I.R.C. § 301. subch. C.
32. *See* I.R.C. § 368(a)(1)(C) (1996).
33. S. 722, § 203(a); I.R.C. § 301, subch. B.
34. S. 722, § 203(e).
35. S. 722, § 204(a)(3).
36. *See* S. 722, § 230.

Section 1060[37] will govern the allocation of the sale price unless the buyer and the seller agree on a different and reasonable allocation.[38]

If another business acquires substantially all of a corporation's assets or a line of the corporation's business or "a separately standing business" of the corporation, the buyer and the seller may jointly elect to treat the transaction as if it were the acquisition of stock of the corporation so that it would be subject to the merger and stock acquisition rules and not to the asset acquisition rules.[39] In effect, the seller would not be taxed on any gain, and the buyer would not be allowed to deduct the purchase price. This provision would require a determination as to when a sale amounted to a sale of "substantially all" of the assets of a business or entity or a line of business. Although present law concepts regarding employee benefits and corporate acquisitions would be useful in making these determinations, some of the legal concepts would be new and would require administrative and judicial interpretation.

If a corporation issued its own stock to acquire assets of another corporation, the transaction would be tax-free, and the buyer would not be allowed to deduct the cost of the assets.[40] If the seller had a basis in the transferred assets, the buyer would assume that basis. The same rule would apply to an acquisition effected by use of stock of a corporation affiliated with the buyer. The application of the stock rules and not the asset rules where the consideration for an asset purchase is stock of the acquiring corporation occurs even if the sale is of only a few assets and is not part of an acquisition of a business. The treatment of the transfer of an asset to a corporation in exchange for the corporation's stock is, thus, similar to the treatment under present section 351,[41] although it is not limited to situations in which the transferor acquires a controlling interest in the transferee.

Under the USA business tax there are no prohibitions against the transfer of net operating loss carryovers in corporate acquisitions similar

37. I.R.C. § 1060 (1996).
38. S. 722, § 212(a); I.R.C. § 301, subch. C.
39. S. 722, § 212(c).
40. S. 722, § 212(e).
41. I.R.C. § 351 (1996).

to those currently applicable under sections 269,[42] 382,[43] and 384[44] of the Internal Revenue Code.

If a shareholder receives a distribution of property from a corporation under the USA tax, the withdrawal of property from the corporation is treated as a withdrawal from savings and may result in tax liability for the shareholder. If the distribution is paid in the form of stock of another corporation or another savings asset, the shareholder will get a corresponding deduction for an addition to savings, and the net effect of the transaction will be a wash. There is no need to distinguish between dividends from earnings and profits and a return of capital as is required under present law. A distribution of property from a corporation to a shareholder is treated as a sale to the shareholder for the property's fair market value.[45] Thus, the sale of a corporation's assets could not be converted into a tax-free transaction by distributing the assets to the shareholders, having the shareholders transfer them to a corporation, and having them then sell the corporation's stock. *General Utilities* remains repealed, even under the USA tax. But not altogether. Here, as in other places, there are exceptions. The constructive sale rule does not apply if a corporation distributes all or a portion of its assets to a controlling business,[46] defined as an entity that owns directly or indirectly more than fifty percent of the profits or capital interest in the corporation.[47] If personal use property is distributed to an individual who contributed the property to the corporation, the fair market value of the property in applying the constructive sale rule will be limited to the property's basis plus "any enhancement in value of the property attributable to business purchases with respect to the property."[48] If a corporation distributes substantially all of the property of a business to another corporation or business organization, the parties can elect to treat the transaction as an asset sale, which is considered a tax-free stock sale under the USA tax.

If a corporation liquidates and distributes cash or assets to an individual, the individual must treat the receipt of the cash and assets as a withdrawal from savings that will increase his or her tax base. If the shareholder receives a financial instrument such as stock or bonds, the transaction will be tax-free; even if the distribution were treated as a

42. I.R.C. § 269 (1996).
43. I.R.C. § 382 (1996).
44. I.R.C. § 384 (1996).
45. S. 722, 104th Cong. § 211(a) (1995).
46. S. 722, § 211(b).
47. S. 722, § 211(d).
48. S. 722, § 211(c).

taxable withdrawal, the shareholder would have an offsetting deduction for the addition to savings.

If a corporation liquidates and distributes business assets to an individual that the individual then uses in a business, the transaction will, in effect, be tax-free to the shareholder because, although the receipt of assets will be treated as a withdrawal from savings, the shareholder will be allowed a deduction for the "purchase" of assets that are used in the new business. If a corporation liquidates and distributes assets to a non-controlling business entity or other corporation, the recipient is treated as if it received the distribution in exchange for its stock in the corporation and, since a business entity is not taxed on the gain from the sale of a financial asset, it will not be taxed on the distribution.

The constructive sale rule applicable to distributions generally applies to distributions in liquidation of a corporation.[49]

A spin-off, split-off, or split-up of a corporation is non-taxable to all parties.[50] Thus, neither the shareholders nor the distributing corporation will be taxed. The bill does not define the terms spin-off, split-off, or split-up. Although these terms have generally understood meanings in the corporate world, are we to infer that the lack of elaboration in the proposed statute means that the bewildering set of requirements for tax-free corporate divisions that have made section 355[51] one of the longer, more incomprehensible, and profitable (for tax lawyers if not for their clients) provisions of the Internal Revenue Code will no longer be with us? While it is certainly possible that the business purpose requirement that has become part of the common law of corporate taxation will continue to apply here as elsewhere under the USA business tax, the active business rules of present law are statutory and would not necessarily carry over to the Nunn-Domenici world.

Tax-free sales of businesses would be easy to accomplish under the USA tax. In fact, the imposition of tax on business acquisitions would be optional. Even if a business were sold for cash, shareholders could avoid tax by reinvesting the sales proceeds in savings assets of any kind. Under the USA tax, the rationale of the current scheme of tax deferral for corporate reorganizations would be eliminated. Under present law, the theory of deferral is that it would be inappropriate to impose tax

49. S. 722, § 211(e).
50. S. 722, § 214.
51. I.R.C. § 355 (1996).

where the target corporation's shareholders retain an interest in their old business through their ownership of the buyer's stock.[52] This concept is implemented through the statutory consideration requirements and the judicial and regulatory requirements of continuity of interest and business enterprise.[53] Under the USA tax, in contrast, gain would be deferred if the target shareholders reinvested the sale proceeds in any form of investment, whether or not it constituted an indirect investment in their old business. Moreover, the ability to sell a business tax-free would be extended to unincorporated businesses. Under present law, an interest in an unincorporated business can be sold tax-free only if the transaction can be arranged as an exchange of like-kind property under section 1031[54] of the Code, which is a rare, although not totally unknown, occurrence.

Under the USA tax, the tax-free nature of a corporate sale at the individual level would not be affected by what happened to the other shareholders. For example, if a person owning one percent of a target corporation's stock exchanged that stock for stock of the acquiring company, the transaction would be tax-free as to that shareholder even if the owners of the other ninety-nine percent of the target corporation's stock sold their stock to the buyer for cash. Thus, the USA tax would eliminate the taxation of all shareholders in the situation in which one of them sells buyer stock after the transaction pursuant to a pre-arranged plan. Currently, this sale can defeat continuity of interest and expose all shareholders to taxation, including those who retained their buyer stock.[55] Under the USA tax, there would be no need for a continuity of interest requirement because any shareholder who transferred his or her buyer stock for cash after the transaction would be subject to tax at that time. Moreover, there would be no need for a continuity of business enterprise requirement because any target shareholder who retained his or her acquiring corporation stock would continue to defer tax on any gain on the sale of the target corporation's stock even if the buyer sold the target's business.

The USA tax in effect treats the totality of an individual's investments in businesses and other enterprises as one aggregate investment. If a

52. C.F.R. § 1.368-1(b) (1996).

53. *Id.* (continuity of interest); C.F.R. § 1.368-1(d) (continuity of business enterprise). the statutory rules are set forth in I.R.C. § 368 (1996).

54. I.R.C. § 1031 (1996).

55. Although the Internal Revenue Service, and, on occasion, taxpayers, have argued where it served their purposes that pre-arranged post-reorganization sales can defeat continuity of interest, this is not clear under present law. *See* Peter L. Faber, *Postreorganization Sales and Continuity of Interest*, 68 TAX NOTES 863 (1005), and cases cited therein.

person sells an interest in one business and reinvests the proceeds in another business, there is no occasion to impose tax because the net amount invested in the individual's business activities has not changed. Another way of looking at the USA tax is that it is like an unlimited section 1033[56] of present law in that gain is effectively avoided whenever the proceeds of the sale are reinvested in other investment property. The big differences are that the definition of similar property is dramatically expanded and there is no time limit for the reinvestment. Moreover, in contrast to section 1033, the USA deferral mechanism operates even if the initial sale is voluntary and is not imposed on an unwilling taxpayer.

THE ARMEY TAX[57]

The Armey tax is basically an income tax in which investment income is exempt. It is a "flat tax" in the sense that most deductions are eliminated. It is not a consumption tax, because the tax is based on certain forms of income without regard to whether they are spent or saved. The exclusion of investment income from the tax base means that a person who saves will be rewarded in the future, but it does not mean that the measure of tax is the amount that a person spends on goods and services.

Although Representative Armey has introduced a bill incorporating his proposal,[58] the bill is a mere skeleton. The bill would have to be considerably expanded and fleshed out for it to be workable, particularly as applied to complex corporate and business transactions. Suggestions will be made from time to time in the next part of this Article for ways in which this might be done.

Under the Armey tax, individuals pay a tax on wages (including pensions but not other fringe benefits) but on nothing else.[59] All income from capital, including interest, dividends, capital gains, and so

56. I.R.C. § 1033 (1996).
57. *See supra* note 2.
58. H.R. 2060, 104th Cong., (1995); S. 1050, 104th Cong., (1995). References in the remainder of this Article will be solely to H.R. 2060, but the same information can be found in the Senate version.
59. *See* H.R. 2060, § 101(a) (as would amend section 63(a) of the 1986 Internal Revenue Code).

forth is not taxed.[60] Thus, gain from the sale of a corporation's stock is not taxed to the selling shareholder. This is true regardless of whether the proceeds are reinvested in another savings asset. Thus, unlike under the USA tax, under the Armey tax the proceeds from the sale of corporate stock could be spent on debauchery and mayhem without the imposition of tax.

Under the Armey tax, a business entity (whether corporate or non-corporate) would be taxed on "gross active income" with deductions for the cost of business inputs and wages (including contributions to retirement plans but not other fringe benefits).[61] Gross active income would include receipts from the sale or exchange of property or services "in connection with a business activity."[62] The statutory language is unclear as to whether the sale of property that is used in a business but that is not held for sale in the business produces gross active income. The words "in connection with" seem to encompass the sale of a plant and equipment as well as inventory, but the language could be clearer. The fact that deductible business inputs include amounts paid for property "sold or used in connection with a business activity" suggest that, to achieve parity, income from the sale of such property should be included in gross active income.[63]

As under the USA tax, the Armey tax provides that a corporation in an expansion mode may defer tax indefinitely. A corporation could borrow money in order to purchase a plant and equipment, obtaining a deduction for the cost. Since the cost of capital equipment would presumably exceed the income generated by it each year, the excess would be available as a carryover, which apparently can go on forever. If the corporation continues to expand, this process can continue indefinitely and the corporation, although making a healthy return on its assets, may never pay tax.

Under the Armey tax, the corporate and individual tax rates would be the same.[64] If this were not the case, taxpayers could "game" the

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60. This exclusion may make the Armey approach politically unattractive. Although one could argue that income that a shareholder receives from a corporation has already been taxed at the corporate level and that the Armey proposal simply amounts to an elimination of a double tax to which wage income is not subject, this argument, while it might be appealing to economists, would be hard to sell to factory workers and, fortunately for the country, there are more factory workers than there are economists.

61. H.R. 2060, 104th Cong. § 102(c) (1995) (as would amend § 11(c) of the 1986 Internal Revenue Code).

62. *Id.*

63. H.R. 2060, § 102 (as would amend section 11(d)(2) of the 1986 Internal Revenue Code).

64. H.R. 2060, § 101, 102 (as would amend § 1 and § 11(a) of the 1986 Internal Revenue Code).

system by manipulating wages. For example, if the corporate rate were lower than the individual rate, a taxpayer who owned all of a corporation's stock and who also worked for the corporation would have an incentive to avoid being paid wages by the corporation. The amounts that were not paid as wages could be kept in the corporation and invested. If the shareholder later sells the stock, the proceeds of the sale would not be taxed, even though the sale price included the value of the accumulated income. One wonders whether an accumulated earnings tax would be added to the Armey tax structure at some point along with other forms of creeping complexity that would undoubtedly surface as congressional staffers became aware of techniques that were being developed by members of the tax bar to subvert the system.

A corporate acquisition structured as a sale of stock by the target shareholders to the acquiring corporation would be tax-free to the shareholders and all corporate parties under the Armey tax. The type of consideration would be irrelevant. Tax-free treatment would be available regardless of whether the consideration consisted of cash, stock, elephants, or a combination of the three. The qualifying consideration rules of the tax-free reorganization provisions of the Code would be repealed, and the continuity of interest and business enterprise doctrines would be laid to rest. Any sale of corporate stock, whether by a minority shareholder or by all of the shareholders as a group, would be tax-free.

The sale of assets by a corporation would, however, be subject to tax under the Armey regime. On the other hand, a later liquidation of the corporation and distribution of sale proceeds to the shareholders would not be taxable to the shareholders. Thus, unlike under the present system, only a single layer of tax would be imposed. The Armey tax does not provide for tax-free sales of assets by corporations. There is nothing analogous to the present law "C" reorganization.[65] Thus, the Armey tax will have a bias in favor of sales of stock by the shareholders rather than sales of assets by the corporation followed by a liquidation. Of course, the corporate buyer of a business may prefer to buy assets because it would be able to deduct the purchase price, whereas it would presumably get no deduction if it bought the stock of another corporation.

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65. *See* I.R.C. § 368(a)(1)(C) (1996).

The Armey tax is unclear as to how a statutory merger would be treated. If a target corporation merged into an acquiring corporation and the acquiring corporation's stock was distributed to the target's shareholders, the transaction would be tax-free at the shareholder level because the shareholder would surrender target company stock in exchange for acquiring company stock. The treatment of the merger at the corporate level is less clear. If the transaction is treated as a transfer of assets by the target corporation followed by a distribution of the acquiring corporation's stock in liquidation, the merger would presumably give rise to a corporate-level tax. This is because no exception is provided to the general rule that a sale of corporate assets is taxable, even if the consideration for the sale is stock of another corporation. A statutory merger has been treated as a sale of assets followed by a liquidation under present law.[66] Under this analysis, the acquiring corporation in a statutory merger should be treated as if it purchased the target company's assets, and it should be able to deduct their cost. Since it would inherit the target company's gain on the sale of its assets, the transaction would presumably be a wash as to the acquiring corporation.

What would happen under the Armey tax if a corporation bought the stock of a target corporation with the intention of liquidating it so as to acquire its assets? The selling shareholders would presumably not be taxed on the gain on the sale of their stock, but should the steps be combined so as to treat the transaction as a sale of assets at the corporate level, as was done by statute under the 1954 Code and by case law before that Code's enactment?[67]

The Armey bill says nothing about the treatment of net operating loss carryovers in corporate acquisitions. They are not extinguished nor is their use limited if there is a change in control of the loss corporation. On the other hand, nothing is said about whether they pass to the surviving corporation in a merger or other acquisition. These issues will have to be addressed if the bill is ever seriously considered by Congress.

The Armey bill also does not address a number of issues involving the use of corporate subsidiaries.

It is unclear whether tax would be imposed if a corporation transferred business assets to a newly-formed subsidiary in exchange for the subsidiary's stock. Literally, the transaction would seem to encompass a sale of assets in exchange for consideration. If this were the result, a major impediment would be placed in the path of organizing and

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66. West-Shore Fuel, Inc. v. United States, 598 F.2d 1236, 1238 (2d Cir. 1979).

67. *See* I.R.C. § 334(b)(2) (1954) (current version at I.R.C. § 334(b) (1986); Kimbell Diamond Milling Co. v. Commissioner, 14 T.C. 74, 80, *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

structuring businesses. It seems likely that some form of present Section 351[68] would have to be added to the bill.

Moreover, the Armey bill does not indicate whether a corporation is taxed on the distribution of appreciated assets to its shareholders as a dividend or a return of capital. If the corporation is not taxed, and if some form of Section 351 is not added to the law, a corporation could effectively sell its assets by transferring them to a new subsidiary, distributing the stock of the subsidiary to its shareholders (who would not be taxed on the receipt), and having the shareholders sell the stock of the subsidiary to the buyer. In fact, it might not be necessary to form a subsidiary; the corporation could simply distribute its assets to its shareholders who could sell them directly without being taxed on their gains. This could lead to a revival of the *Court Holding Company/Cumberland Public Service* problem of determining who should be considered the "seller,"[69] thus ensuring the continued employment of tax lawyers for generations to come.

The Armey bill is also unclear as to whether the stock of a corporate subsidiary will be treated as "property . . . used in connection with a business activity."[70] If it is, a corporate purchaser of another corporation's stock will be able to deduct the purchase price. If it is not, then such a purchase will not be deductible. Similarly, the bill is unclear as to whether a corporation that liquidates a subsidiary will be treated as purchasing the subsidiary's assets so as to be able to deduct the cost.

In short, the application of the Armey tax to corporate transactions leaves many unanswered questions. The answers are not intuitively obvious given the objectives of the Armey tax regime.

CONCLUSION

The USA tax and the Armey tax would both achieve substantial tax exemption for corporate acquisitions at the shareholder level. When the focus of the tax is shifted, in one case to consumption and in the other to active business income, the realization of investment gain, which is an essential component of the tax base under the current system,

68. I.R.C. § 351 (1996).

69. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950).

70. H.R. 2060, 104th Cong. § 102 (1995) (as amending § 11(d)(2)(A)(i) of the 1986 Internal Revenue Code).

becomes largely irrelevant. Tax issues would be presented at the corporate level, but they would likely be less complicated than those that arise under the present regime.

If one of these proposals, or something similar, becomes law, it is likely that a large part of the tax planning for corporate acquisitions would shift from the federal to the state and local level, where issues of apportionment, nexus, and sales tax would continue to be present. Of course, the replacement of the federal income tax system would have significant consequences for the states and might lead to a restructuring of existing state and local tax systems.[71]

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71. *See generally*, Dan R. Bucks et al., *Federal Tax Restructuring and State and Local Governments: An Introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459 (1997).