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Ulysses S. Crockett Jr.

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Federal Taxation of Corporate Unifications: A Review of Legislative Policy

*Ulysses S. Crockett, Jr.**

Introduction

Historically and presently, corporate unifications[1] have played a significant role in the economic development of the United States.[2] Beginning with the 1918 Revenue Act,[3] Congress accorded special treatment to mergers and certain other business unifications; transfers of stock in corporate reorganizations are currently afforded tax-free treatment through nonrecognition of gain under sections 354, 355 and 356 of the Internal Revenue Code.[4] These tax advantages

* A.B., J.D., University of California at Berkeley; Member of the Faculty of Law, Cleveland State University.

1. The term "unifications" includes the acquisition by one corporation of ownership control over another corporation by statutory merger under INT. REV. CODE OF 1954, § 368(a)(1)(A); mutual exchanges of voting stock under *id.* § 368(a)(1)(B); exchanges of voting stock for assets under *id.* § 368(a)(1)(C); and certain forms of liquidations under *id.* §§ 331, 337. Although distinctions may be drawn between these various forms of business adjustments, there is arguably sufficient similarity among the unifying reorganizations for the same tax treatment to govern all such transactions. They commonly involve the unification of two separate business entities into another business entity controlled by the owners of the two previously separate entities. *See generally* Hellerstein, *Mergers, Taxes, and Realism,* 71 HARV. L. REV. 254 (1957) [hereinafter cited as Hellerstein]. *See also* 2 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 786-94 (1973) [hereinafter cited as SURREY].

2. For an appreciation of the historical significance of merger growth see J. BUTTERS, J. LINTNER & W. CARY, EFFECTS OF TAXATION ON CORPORATE MERGERS (1951); J. WESTON, THE ROLE OF MERGERS IN THE GROWTH OF LARGE FIRMS (1953). For more extensive examinations of the role of mergers in corporate growth see R. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY, 1895-1956 (1959); G. NUTTER, EXTENT OF ENTERPRISE MONOPOLY IN THE UNITED STATES (1951).

3. Act of Feb. 24, 1919, ch. 18, 40 Stat. 1057.

4. *See* INT. REV. CODE OF 1954, §§ 354-56.

encouraged the burgeoning merger activity and resulting industrial asset concentration in the twentieth century.[5] When the modern industrial period was emerging at the turn of the century, the tax subsidy helped to promote necessary economic growth. Today, the economy no longer demands that federal tax laws provide an impetus for further industrial asset concentration. This article will trace congressional treatment and response to merger activity and the developing laws. Having established the historical perspective, it will examine some of the economic effects of mergers on shareholders, corporations, and the public treasury.

I. An Historical Perspective

A. *Early Tax Treatment of Reorganizations*

Prior to 1918, corporate unifications were treated for tax purposes like any other sale of property;[6] revenue acts contained no provisions allowing tax-free corporate reorganizations. The 1918 Revenue Act was the first statute to deal specifically with the question of recognition or nonrecognition of gain or loss on the exchange of property. The law provided for nonrecognition of gain in reorganization exchanges when the stock or securities received had a par value equal to, or less than, the par value of the securities exchanged.[7] Before

5. Staff of House Select Comm. on Small Business, 87th Cong., 2d Sess., Mergers and Superconcentrations 9 (1962). Industrial asset concentration refers to assets held and sales made by fewer firms and controlled by fewer ownership units. Most studies use aggregate assets as a measure of concentration. Relative concentration, by contrast, measures the percent of market shares held by one business entity relative to the shares of other entities doing business in the same market. Thus, relative concentration is a more accurate measure of the market power of a firm in terms of competitive standing in a given market. *See* E. Singer, Antitrust Economics 136-39 (1968). This article will generally focus on aggregate assets as a measure of concentration, and will refer to this measure as "industrial asset concentration."

The article will examine the way in which the federal income tax laws subsidize corporate mergers and it will illustrate some of the economic effects of mergers. It will not compare this influence of the tax laws with other management considerations which induce corporate mergers.

6. Generally, where a shareholder of one corporation sold all or part of his interest in exchange for an ownership interest in another corporation, the taxation of gain depended on the relative similarity and extent of interest obtained in the new corporation. *See, e.g.*, Marr v. United States, 268 U.S. 536 (1925); Cullinan v. Walker, 262 U.S. 134 (1923); United States v. Phellis, 257 U.S. 156 (1921); Rockefeller v. United States, 257 U.S. 176 (1921); Eisner v. McComber, 252 U.S. 189 (1920). *See also* Hall, *Exchange of Securities in Corporate Reorganization as Income*, 20 Ill. L. Rev. 601 (1926); Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 Yale L.J. 623 (1967).

7. Act of Feb. 24, 1919, ch. 18, § 202(b), 40 Stat. 1060. The second paragraph of § 202(b)

the Act's passage, congressional debate on the bill had focused on the characterization of a reorganization. Proponents of nonrecognition argued that in comparison to other exchanges of property, corporate reorganizations were "purely paper transactions";[8] disregarded were the potential distortive effects, however small, upon capital markets and the industrial structure occasioned by such a provision. Instead, it was argued nonrecognition would aid in the administration of tax laws.[9] Those who opposed nonrecognition countered that regardless of the nature of reorganizations, businesses would use them to avoid taxation of corporate profits,[10] and that taxing reorganization transactions would lead to few hardships. Despite the protests, nonrecognition became the general rule.[11] Thus, Congress cleared the way for the loss of a vast amount of revenue by statutorily permitting reorganizing corporations to escape taxation.

Arguably, the reorganization provisions of the Act were illogical in at least three ways. First, immunity from tax depended merely on the par value of securities involved in the reorganizations.[12] Second, the Act did not contain definitions of the terms

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provided for nonrecognition of loss where new stock or securities of lower par value were received in connection with a reorganization, merger or consolidation, but it did not specifically provide for the recognition of loss where the aggregate par or face value of the new stock or securities transferred was in excess of the aggregate par or face value of the stock or securities received. The second paragraph of § 202(b) was construed to apply only where a gain was realized. If no gain was realized, it was necessary to rely on the first paragraph of § 202(b), which treated property as the equivalent of cash to the extent of its fair market value. *See* I.T. 2024, III-1 CUM. BULL. 54 (1924), *overruling* O.D. 932, 4 CUM. BULL. 46 (1921), *and approving* O.D. 970, 5 CUM. BULL. 61 (1921).

8. S. REP. No. 617, 65th Cong., 3d Sess. 5-6 (1918), 1939-1 CUM. BULL. 117, 120.

9. The Secretary of the Treasury suggested four instances where transactions should be included in the nonrecognition provision because of the administrative difficulties in computing gain or loss involved: (1) when the market value of the property received cannot satisfactorily be determined; (2) when the property is exchanged for all, or substantially all, of the stock of the corporation; (3) when property is exchanged between affiliated corporations; and (4) when, in connection with the reorganization of a corporation or partnership, one entity exchanges property with another entity involved in such reorganization. *See* SECRETARY OF THE TREASURY, NOTES ON THE REVENUE ACT OF 1918 SUBMITTED TO THE SENATE FINANCE COMM. AND THE HOUSE WAYS AND MEANS COMM. 7-8 (1919). Some of the recommendations are now codified at INT. REV. CODE OF 1954, §§ 368(a)(1)(B)-(C), 351.

10. 57 CONG. REC. 828-29 (1918). *See also* S. REP. No. 617, 65th Cong., 3d Sess. 3-4 (1918), 1939-1 CUM. BULL. 117, 120.

11. 57 CONG. REC. 828-29 (1918).

12. *See* R. PAUL, FEDERAL TAXATION 19 (1940). Additionally, the issuance of no par stock was ruled not to escape from valuation. *See* Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98, 102 (1938) [hereinafter cited as Sandberg].

"reorganization," "merger," or "consolidation"; these definitions were necessary to interpret which transactions would be exempt. Third, the Act gave nonrecognition treatment to exchanges among individual taxpayers, not corporations. Subsequently, in 1921, Congress did define the term "reorganization";[13] it amended the statute to permit the receipt of "boot," which is money or other property received in addition to stock or securities in a transaction, without making the entire transaction taxable;[14] and it provided that a reorganization exchange was nontaxable despite differences in the par value of transferred securities.[15]

The Revenue Act of 1924[16] permitted nonrecognition of gain if a corporation operating a subsidiary corporation transferred part of the parent corporation's assets in exchange for all of the subsidiary's stock and later distributed the stock as a dividend to the parent's shareholders without surrender by the stockholders of any of their stock.[17] The congressional rationale for this provision was that the kinds of exchanges covered were merely changes in form from which no income was realized at the time of the exchange.[18] In the Revenue Act of 1924, nonrecognition provisions were extended to corporations as well as to shareholders.[19] The basis provisions for property acquired by a corporation in a reorganization exchange were altered

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13. The Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230 provided in part:

> The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation . . . .

14. Act of Nov. 23, 1921, ch. 136, § 202(e), 42 Stat. 230.

15. Act of Nov. 23, 1921, ch. 136, §§ 202(c)(1)-(3), 42 Stat. 230. Statutory correlation of the reorganization and basis provisions was also completed by the Revenue Act of 1921, ch. 136, § 202(e), 42 Stat. 230.

16. Act of June 2, 1924, ch. 234, § 203(c), 43 Stat. 256.

17. *See* H.R. Rep. No. 179, 68th Cong., 1st Sess. 7 (1924), 1939-1 Cum. Bull. 241, 250-53; S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924), 1939-1 Cum. Bull. 266, 275-78.

18. This rationale was later used to explain the extension of the nonrecognition exemption to corporations. Regarding the parent corporation's interest in the formerly controlled subsidiary corporation, however, it is difficult, if not impossible, to see the transaction as "continuing," especially where the parent corporation simultaneously turns over all or part of the consideration it receives to the shareholders. This situation, taken with the fact that the acquiring corporation might be allowed a stepped-up basis, makes it difficult to appreciate the argument that the tax was merely postponed. *See* Sandberg, *supra* note 12, at 99 n.4, 103.

19. Act of June 2, 1924, ch. 234, § 203(b)(3), 43 Stat. 256.

by the Revenue Act of 1928[20] so that these assets would retain the same basis for the new corporation as they had for the old corporation.[21] This substituted basis rule was limited, however, to cases where an interest or control of 80 percent or more of the assets remained in the same person.[22] In an attempt to prevent tax avoidance, the substituted basis limitation was reduced to 50 percent by the Revenue Act of 1932.[23]

A new limitation was imposed on tax-free reorganizations by the Revenue Act of 1934;[24] nonrecognition was denied where shares of stock or securities were not in fact exchanged for stock or securities in the original corporation. The definition of reorganization was qualified so that nonrecognition status was conferred only on statutory mergers or consolidations in which the acquiring corporation transferred all or part of its voting stock in exchange for the assets or stock of the acquired corporation.[25] In addition, the acquisition by one corporation of stock of another corporation was excluded from the exemption unless (1) at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock were acquired, or (2) unless substantially all of the property of the other corporation was acquired in the transaction.[26]

20. Act of May 29, 1928, ch. 852, § 113(a)(8), 45 Stat. 820. Under the Revenue Act of 1926, ch. 27, § 204(a)(8), 44 Stat. 15, no gain or loss was recognized if property was transferred to a corporation solely in exchange for its stock, and if immediately after the transaction, the transferor was in control of the corporation. Generally, in such cases, the basis of the property in the hands of the corporation would be the same as the basis of the property in the hands of the transferor. However, § 204(a)(8) was not applied in the case where the property acquired by the corporation consisted of stock or securities in a corporation that was a party to the reorganization. The Revenue Act of 1928, ch. 852, § 113(a)(8), 45 Stat. 820, corresponded to § 204(a)(8), but omitted this restriction in the reorganization exchanges. Additionally, in the Revenue Act of 1928, a substituted basis was provided in the case where the stock or securities were acquired by a corporation in exchange for the issuance of its own stock or securities. Act of May 29, 1928, ch. 852, § 113(a)(7), 45 Stat. 819. *See* H.R. Rep. No. 2, 70th Cong., 1st Sess. 18 (1927), 1939-1 Cum. Bull. 384, 397; S. Rep. No. 960, 70th Cong., 1st Sess. 27-28 (1928), 1939-1 Cum. Bull. 409, 428.

21. *See* H.R. Rep. No. 708, 72d Cong., 1st Sess. 26 (1932), 1939-1 Cum. Bull. 457, 471.

22. Revenue Act of 1928, ch. 852, § 113, 45 Stat. 818.

23. Act of June 6, 1932, ch. 209, § 113(a)(7), 47 Stat. 199. The rationale for this change was expressed by the Senate Finance Committee:

> This 80 per cent limitation has been reduced to 50 per cent to check tax avoidance, for the reason that experience indicates it is easy to secure a temporary investment of 21 per cent of friendly capital in the new corporation and thereby secure a stepped-up basis for the property transferred.

S. Rep. No. 665, 72d Cong., 1st Sess. 27 (1932), 1939-1 Cum. Bull. 496, 516.

24. Act of May 10, 1934, ch. 277, §§ 112(a)-(d), 48 Stat. 704.

25. Act of May 10, 1934, ch. 277, § 112(g)(1), 48 Stat. 705.

26. Act of May 10, 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 705.

The House and Senate had proposed opposing amendments to the existing definition of the term "reorganization." The House bill would have eliminated acquisitions from the term.[27] The Senate view[28] prevailed, however, and acquisitions continued to be afforded nonrecognition status. It was argued that elimination of nonrecognition treatment would produce little additional revenue, particularly because of the slumping national economic conditions at the time.[29]

Nonrecognition status was given to liquidations by the 1935 Revenue Act.[30] A corporation could acquire control of another corporation, then liquidate the purchased corporation without tax effect. A more comprehensive definition of liquidation was established in the Revenue Act of 1936,[31] which also provided that the basis of property received in a liquidation would be the same as it was for the transferor.[32] The 1938 Revenue Act,[33] further amending the liquidation provisions, provided relief to the parent corporation in the event of loss in the subsequent sale of property received in the liquidation.[34] Congress, in attempting to alleviate some of the effects of the depression, thus provided additional impetus toward increased control of the industrial economy by fewer corporate entities. This incentive was increased by the Revenue Act of 1939,[35] which permitted the assumption of liabilities in reorganization exchanges.[36] Furthermore, in response to the deteriorating condition of the railroad industry, Congress allowed nonrecognition of gain in bankruptcy rail-

27. H.R. REP. No. 704, 73d Cong., 2d Sess. 14 (1934), 1939-1 CUM. BULL. 554, 563-65.

28. *See* S. REP. No. 558, 73d Cong., 2d Sess. 16 (1934), 1939-1 CUM. BULL. 586, 598-99. The Senate's rationale for including these acquisitions within the reorganization provisions was that acquisitions sufficiently resembled mergers and consolidations to be afforded similar treatment.

29. *Hearings on Revenue Revision Before the House Ways and Means Comm.*, 73d Cong., 1st Sess. 57 (1933).

30. Act of Aug. 30, 1935, ch. 829, § 110(a), 49 Stat. 1020.

31. Act of June 22, 1936, ch. 690, § 112(b)(6), 49 Stat. 1679.

32. Act of June 22, 1936, ch. 690, § 113(a)(15), 49 Stat. 1684.

33. Act of May 28, 1938, ch. 289, 52 Stat. 447 (passed over presidential veto).

34. Act of May 28, 1938, ch. 289, § 112(7), 52 Stat. 487. *See* H.R. REP. No. 2330, 75th Cong., 3d Sess. 18 (1938), 1939-1 CUM. BULL. 817, 822-23; S. REP. No. 1567, 75th Cong., 3d Sess. 17 (1938), 1939-1 CUM. BULL. 779, 783-84.

35. Act of June 29, 1939, ch. 247, § 213(a), 53 Stat. 870. *See* H.R. REP. No. 855, 76th Cong., 1st Sess. 19 (1939), 1939-2 CUM. BULL. 504, 518.

36. *See* United States v. Hendler, 303 U.S. 564 (1938) (liabilities in a corporate reorganization treated as "boot"). For the current treatment of liabilities assumed in reorganizations and attendant problems of basis determinations see Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1358-59 (1962).

road reorganizations under the 1942 Revenue Act.[37] The public interest in continued railway service was proferred as the justification; the implications for industrial asset concentration were ignored.[38]

B. *Tax Policy of Corporate Unifying Reorganizations After 1940*

The most recent period of merger activity began in 1940 and reached its peak in 1968.[39] Between 1967 and 1968 alone, over $15 billion in assets were acquired[40]—significantly more than the amount of assets acquired in the first merger movement between 1890 and 1904,[41] and nearly matching the movement in the 1920's.[42]

37. Act of Oct. 21, 1942, ch. 619, § 142, 56 Stat. 838. The Act also provided that in the case of railroad reorganizations which met the specified requirements, the basis of the property acquired would be the same as the basis of the property in the hands of the old corporation. Act of Oct. 21, 1942, ch. 619, § 142(b), 56 Stat. 839. *See* INT. REV. CODE OF 1954, § 374(b).

38. *See* S. REP. No. 1631, 77th Cong., 2d Sess. 48 (1942), 1942-2 CUM. BULL. 504, 544. Congressional regulation of the railway industry, along with these tax allowances to controlling corporations, closed this industry from healthy competition. The industry was easily monopolized because of the high costs of investment and maintenance, its limited market with the advent of the automobile, and the seasonal demand for railroad transportation.

39. FTC, ECONOMIC REPORT: CONGLOMERATE MERGER PERFORMANCE 11, 14 (1972) [hereinafter cited as 1972 FTC REPORT].

40. *See* BUREAU OF ECONOMICS, FTC, ECONOMIC PAPERS 1966-69, Table 1, at 287 (1969) [hereinafter cited as 1969 FTC PAPERS]. In 1950, acquired assets amounted to only 3.2 percent of new investments, whereas in 1968, acquired assets increased to 54.6 percent of new investments. In 1968, over 35 percent of the total increases in assets over prior years were generated by mergers. For a detailed discussion of the effects of tax laws on merger growth after 1940 see Markham, *Growth Incentives and Antitrust Policy*, in WHAT PRICE ECONOMIC GROWTH? 92 (K. Knorr & W. Baumol eds. 1961). *See generally* E. MASON, ECONOMIC CONCENTRATION AND THE MONOPOLY PROBLEM (1957).

41. Early mergers of companies from 1890 to 1904 have been characterized as "mergers for monopoly"; their principal objective was to gain control of markets by combinations of competitors and areas of production. STAFF OF HOUSE COMM. ON SMALL BUSINESS, 87TH CONG. 2D SESS., MERGERS AND SUPERCONCENTRATIONS 9 (1962). There were 92 mergers between 1893 and 1903; of these, 78 resulted in control of more than 50 percent of the output of the respective industries. J. MOODY, THE TRUTH ABOUT TRUSTS 488 (1904). This period of merger activity—the fastest merger growth period in the country's history—can be attributed to the expansive nature of the economy at the turn of the century and the lack of antitrust law enforcement. Once the Supreme Court, in Northern Sec. Co. v. United States, 193 U.S. 197 (1904), determined that the Sherman Anti-Trust Act of 1890, ch. 647, §§ 1-8, 26 Stat. 209 (codified, as amended, at 15 U.S.C. §§ 1-7 (1970)), applied to mergers which resulted in market domination and restraint of trade, the merger movement declined. For a thoughtful discussion of the role of antitrust law enforcement during the period of 1900 to 1950 see R. HOFSTATTER, *What Happened to the Antitrust Movement?*, in THE PARANOID STYLE IN AMERICAN POLITICS AND OTHER ESSAYS 188 (1965).

42. Smaller companies, which sought to improve their market positions by combining, dominated merger activity between 1919 and 1930. During this period, industries which were traditionally composed of smaller businesses, and which had previously been almost un-

Most prevalent among the reasons for mergers since 1940 has been the desire to move into new product lines or geographic areas; to grow by merger rather than by internal growth has become commonplace.[43] Financial advantages which generally accompany mergers were sought—to afford larger sales over which fixed costs may be allocated; to use one company's excess cash to acquire needed working capital for the other party to the merger; to improve a corporation's debt-equity ratio; to secure increases in earnings per share and bolster market prices of stock; and to acquire sufficiently larger sales revenue to support extensive advertising and promotional activities. Management goals, such as the acquisition of key sales, technical and management personnel, may also have motivated recent mergers.[44]

Tax provisions continued to provide a favorable climate for reorganizations during this period. Nonrecognition status afforded railroad reorganizations was extended to other bankruptcy reorganizations by the Revenue Act of 1943.[45] The "boot" rule was applied to bonds received in a reorganization or recapitalization exchange under the Internal Revenue Code of 1954,[46] but recognition of loss to either the corporation[47] or to its shareholders[48] was discontinued. In contrast to prior law, the acquiring corporation could, under the 1954 Code, transfer its voting stock to a subsidiary of the acquiring corporation in exchange for assets without tax effect.[49] Moreover, a transfer would qualify as a reorganization even though control of the transferee corporation belonged to the transferor corporation or its

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touched by mergers, formed new consolidations and expanded through acquisitions. Since the Clayton Act § 7, ch. 323, § 7, 38 Stat. 731 (1914), *as amended* 15 U.S.C. § 18 (1970), prohibited stock purchases that substantially lessened competition, a predominant feature of these mergers was that many acquirers absorbed assets rather than purchased stock, thus circumventing the effect of the statute. This "loophole" in the statute remained until amendment by the Celler-Kefauver Act, 15 U.S.C. § 18 (1970), *formerly* ch. 1184, 64 Stat. 1125 (1950). *See* J. BLAIR, ECONOMIC CONCENTRATION ch. 11 (1972).

43. *See Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 7, at 2411 (1969) (statement of Willard Mueller) [hereinafter cited as 1969 *Tax Reform Hearings*].

44. *But cf.* 1972 FTC REPORT, *supra* note 39, at 33-60 (results of study of conglomerate merger activity indicate few far-reaching changes in managerial operations of acquired companies were made and no discernible effect on their profitability appeared after acquisition).

45. Act of Feb. 25, 1944, ch. 63, § 121, 58 Stat. 41.

46. INT. REV. CODE OF 1954, § 356(d).

47. *Id.* § 361(b)(2).

48. *Id.* § 356(c).

49. *Id.* § 368(a)(2)(C).

shareholders.[50] Such a transfer would not have qualified under previous law since it failed to meet the "continuity of interest" test[51] required for a reorganization exchange.

An attempt by the House of Representatives to restrict the reorganization provisions by changes in the definition of the kinds of transactions which could qualify was unsuccessful in 1954.[52] Under the House proposal, statutory mergers and consolidations would have been denied the status of nontaxable transactions unless otherwise constituting "corporate acquisition of property."[53] The bill provided that if any corporation, other than a "publicly held" corporation,[54] was more than four times the size of the other participating corporation, the merger was taxable.[55] This eliminated "recapitalizations" from the nonrecognition provisions and treated such transactions as stock dividend distributions.[56] The proposed

50. *Id.*

51. Pursuant to the Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(B), 53 Stat. 40, *as amended*, INT. REV. CODE OF 1954, § 368(a)(1)(B), the continuity of interest doctrine required that when one corporation acquired another in a stock-for-stock or stock-for-asset acquisition, the acquisition had to be solely for the voting stock of the acquiring corporation. The doctrine was intended to prevent outright sales and dividends from receiving nonrecognition treatment in a reorganization. To meet the same objective, under present regulations the Internal Revenue Service requires continuity of interest in at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the effective date of the reorganization. Treas. Reg. § 1.368-1(b) (1955). *See* Rev. Proc. 66-34, 1966-2 CUM. BULL. § 3.02, at 1233. *See also* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), decided under § 203(h)(1)(A) of the Revenue Act of 1926, ch. 27, 44 Stat. 9. Acquisition by selling shareholders of short-term purchase money notes was ruled not a sufficient interest in the affairs of the purchasing corporation to justify exemption. In Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935), a transfer of assets for stock amounting to 7½ percent of the transferee's outstanding stock plus cash qualified as a reorganization. The test applied by the Court was whether the interest acquired in the transferor corporation was "definite and substantial" and represented a "material part of the value of the transferred assets." *Id.* at 386. For a discussion of the modern application of the continuity of interest doctrine see Deming, *How "Solely" is "Solely for Voting Stock": Current Problems in "B" and "C" Reorganizations*, 29 N.Y.U. 29TH INST. ON FED. TAX. 397 (1971).

52. The House bill of 1954 abandoned the term "reorganization"; instead, it designated certain kinds of transactions, such as corporate acquisitions of stock and corporate acquisitions of property, as tax-exempt. *See* H.R. 8300, 83d Cong., 2d Sess. §§ 359(b)-(d) (1954).

53. *Id.* § 359(c).

54. A corporation was deemed publicly held unless 10 or fewer shareholders owned stock entitling them to more than 50 percent of the vote of all the stock outstanding, or held stock with a value equal to more than 50 percent of the total value of all the outstanding stock. H.R. REP. No. 1337, 83d Cong., 2d Sess. 132 (1954), U.S. CODE CONG. & AD. NEWS 4025, 4269-70 (1954).

55. H.R. 8300, 83d Cong., 2d Sess. §§ 359(a), (b)(2), (c)(1) (1954).

56. *See* H.R. 8300, 83d Cong., 2d Sess. § 359 (1954).

House revisions were criticized for limiting legitimate business transactions and for being particularly oppressive to the development of smaller corporations;[57] eventually, the proposals were abandoned.[58]

However, as finally enacted, the Internal Revenue Code of 1954 incorporated significant changes in the tax treatment of mergers and consolidations incident to a corporate reorganization. By express statutory provision, a corporation could transfer part or all of the assets it acquired to a corporation which it controlled, without affecting the reorganization status of the merger or consolidation.[59] The former requirement that sufficient stock to give "control" be acquired in exchange for voting stock was eliminated. Under the new law, nonrecognition applied to acquisitions of stock which represented a controlling interest in a corporation, acquisitions of additional stock sufficient to give control to an acquiring corporation which previously did not have control, and additional acquisitions by a corporation already in control.[60] In a stock-for-asset transfer, up to 20 percent "boot" was permitted to be received under specified conditions.[61] The parent corporation of the acquiring corporation was included in the definition of a "party to a reorganization."[62]

Prior to 1954, the Internal Revenue Service was authorized to disallow a deduction, credit, or allowance, not otherwise available, in cases where control of a corporation was acquired principally for the purpose of tax evasion or avoidance. The effectiveness of this authorization was impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition.[63] The Senate Finance Committee, therefore, recommended that in a corporate acquisition, the burden of proof should be placed on a taxpayer to show a purpose other than tax avoidance. This recommendation became a provision of the 1954 Code.[64] Another Senate

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57. *Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83d Cong., 2d Sess., pt. 1, at 533-59 (1954).

58. *See* H.R. REP. No. 2543, 83d Cong., 2d Sess. 34 (1954), U.S. CODE CONG. & AD. NEWS 5280, 5298-301 (1954).

59. INT. REV. CODE OF 1954, § 368(a)(2)(C).

60. *Id.* § 368(a)(1)(C). *See* S. REP. No. 1622, 83d Cong., 2d Sess. 273 (1954), U.S. CODE CONG. & AD. NEWS 4793, 4911 (1954).

61. INT. REV. CODE OF 1954, § 368(a)(2).

62. *Id.* § 368(b).

63. H.R. REP. No. 1337, 83d Cong., 2d Sess. 41 (1954), U.S. CODE CONG. & AD. NEWS 4025, 4067 (1954).

64. *See* INT. REV. CODE OF 1954, § 269.

proposal, included in the 1954 Code as section 381, provided that a corporation which took over the assets of another corporation in a tax-free statutory merger, consolidation, corporate acquisition of property, or in a complete liquidation of a subsidiary by its parent, would carry over certain of the tax attributes of the corporation which went out of existence.[65] The Senate Finance Committee drafted a provision to limit the loss carryover relating to purchases of stock of a corporation with a history of losses in circumstances where the loss carryover was used to offset gains of an unrelated business.[66] The committee recommendation provided that if more than 50 percent of the stock of a corporation was purchased within a two-year period, and if the corporation thereafter engaged in a different kind of business, the loss carryover would be eliminated. The provisions were adopted[67] despite criticisms articulated in the minority report accompanying the House version of the bill. The minority report specifically noted that corporations were given additional opportunities for tax manipulation and shareholders were enabled to withdraw corporate earnings and profits and escape from the higher individual surtax rates on dividends.[68]

Section 19 of the Revenue Act of 1958[69] extended to minority shareholders the benefits of section 337 of the 1954 Code, a provision for nonrecognition of gain or loss in connection with a complete corporate liquidation where 80 percent or more of the corporation was owned by another corporation.[70] In 1959, hearings before the House Ways and Means Committee focused upon three areas pertinent to corporate reorganizations: statutory mergers, stock-for-stock

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65. *Id.* § 381; *See Hearings on H.R. 8300 Before the Senate Comm. on Finance,* 83d Cong., 2d Sess., pt. 3, at 1543.

66. S. REP. No. 1622, 83d Cong., 2d Sess. 39-40 (1954), U.S. CODE CONG. & AD. NEWS 4621, 4684 (1954).

67. *See* INT. REV. CODE OF 1954, §§ 269(a)(2), 382(a)-(b).

68. The report stated:

> Under the guise of removing obsolete language and inequitable provisions from present tax laws, the bill reduces taxes substantially for businesses, primarily corporations, and a few selected groups of individual taxpayers . . . .
>
> The tax reductions indulged in by the majority in this bill show a singular purpose to benefit a small minority of taxpayers at the expense of a substantial revenue loss, to the almost complete exclusion of the average taxpayer.

H.R. REP. No. 1337, 83d Cong., 2d Sess. B1 (1954), U.S. CODE CONG. & AD. NEWS 4025, 4594-95 (1954).

69. Act of Sept. 2, 1958, Pub. L. No. 85-866, § 19, 72 Stat. 1615, *amending* INT. REV. CODE OF 1954, § 337.

70. *See* S. REP. No. 1983, 85th Cong., 2d Sess. 29-31 (1958), 1958-3 CUM. BULL. 950-52.

acquisitions in practical mergers,[71] and loss carryovers under sections 381(c)(1) and 382 of the 1954 Code.[72] Some Congressmen were especially concerned about corporate use of the tax merger provisions to effectuate further asset concentration.[73] To discourage taxpayers from acquiring a corporation solely for its carryover of loss, an advisory group suggested that a carryover by an acquired corporation should be limited to 50 percent of what was paid for the business by the new owners. Congrees did not approve such a limitation until 1971.[74]

Prior to 1964, a subsidiary corporation could not acquire the stock of another corporation in exchange for stock of its parent corporation without tax implications. The subsidiary had to transfer its own stock for the exchange to retain nonrecognition status.[75] The 1964 Revenue Act amended the 1954 Code to allow nonrecognition treatment in a stock-for-stock acquisition using the stock of the parent of the acquiring corporation.[76] The definition of "party to a reorganization" was also amended to include the parent corporation of the corporation to which acquired assets or stock were transferred in a

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71. The term "statutory merger" refers to those mergers permitted under INT. REV. CODE OF 1954, § 368(a)(1)(A) which have been effected pursuant to the corporation laws of the United States or of a state, territory or the District of Columbia. *See* Treas. Reg. § 1.368-2(b) (1955). Practical mergers are defined in INT. REV. CODE OF 1954, §§ 368(a)(1)(B)-(C).

72. An advisory group had attempted to distinguish between those cases where a reorganization is effected solely to obtain the benefits of a loss carryover under INT. REV. CODE OF 1954, § 382, and cases where the primary purpose of the reorganization is to acquire the business. *Hearings on Recommendations on Subchapters C, J and K of the Internal Revenue Code Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 420 (1959).

73. Chairman Wilbur Mills of the House Ways and Means Committee remarked:

> As a result of [the present tax treatment to corporate mergers], we must be concerned about a very important policy matter. As you know, Congress is always faced with the problem of concentration in industry. That matter is before some committee of Congress for consideration almost every week that the Congress is in session. We should, therefore, not only look to tax perfection and consequences in this area, but we must also look to see whether or not our action makes it easier to accomplish further concentration in industry.

Id. at 412-13.

74. *See* Act of Dec. 10, 1971, Pub. L. No. 92-178, § 302, 85 Stat. 521 (codified at INT. REV. CODE OF 1954, § 382(a)(1)(A)).

75. S. REP. No. 830, 88th Cong., 2d Sess. 74 (1964), U.S. CODE CONG. & AD. NEWS 1673, 1755 (1964).

76. Act of Feb. 26, 1964, Pub. L. No. 88-272, §§ 218(a)-(b)(1), 78 Stat. 57, *amending* INT. REV. CODE OF 1954, §§ 368(a)(1)(B), (2)(C). The Act permitted a controlling corporation to transfer to its subsidiary part or all of the assets or stock which were acquired in a transaction without disqualifying the transaction from the reorganization provisions.

statutory or practical merger.[77] Correspondingly, the 1968 Revenue Act afforded nonrecognition status to a statutory merger achieved through the exchange of the stock of the parent of the acquiring corporation for that of the acquired company.[78]

In 1969, increased congressional concern over merger activity in general and conglomerate activity in particular was manifested at hearings conducted by the House Ways and Means Committee. The Committee received extensive testimony regarding merger incentives and the effects of conglomerate mergers on industrial asset concentration; it heard various suggestions for curbing conglomerate growth.[79] Noting that the existing tax laws provided benefits for corporations which used indebtedness in corporate acquisitions and thus stimulated merger activity,[80] the committee sought to restrict this use of indebtedness. As a result, the following amendments were enacted in 1969: (1) disallowance of interest deductions for debt instruments issued in connection with a corporate acquisition where the bonds are closely akin to equity;[81] (2) authorization of the

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77. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 218(b)(2), 78 Stat. 57, *amending* INT. REV. CODE OF 1954, § 368(b).

78. Act of Oct. 22, 1968, Pub. L. No. 90-621, § 1(a), 82 Stat. 1310 (codified at INT. REV. CODE OF 1954, § 368(b)(2)). In 1971, Congress further broadened the reorganization provisions by extending nonrecognition treatment to statutory mergers using voting stock of the corporation controlling the merged corporation. Act of Jan. 12, 1971, Pub. L. No. 91-693, § 1(a), 84 Stat. 2077 (codified at INT. REV. CODE OF 1954, § 368(a)(2)(E)).

79. *See* 1969 *Tax Reform Hearings*, *supra* note 43, at 2363-550. Conglomerate mergers, essentially, are mergers that involve neither horizontal nor vertical acquisitions. Horizontal acquisitions are consolidations of firms that are direct competitors in the same geographic market. Vertical mergers combine firms that previously had actual or potential buyer-seller relationships. The merger activity of the late 1960's was dominated by the rapid growth of conglomerates. Although conglomerate mergers may not have the obvious competitive impact of horizontal or vertical combinations, they effect substantial organizational changes in industry: single-market companies are replaced by multi-market ones. 1972 FTC REPORT, *supra* note 39, at 15-18. There have been recent challenges to conglomerate mergers under section 7 of the Clayton Act; antitrust law enforcement, however, has mainly been concerned with vertical and horizontal mergers. Some commentators have pressed for more aggressive use of antitrust law to bar conglomerate mergers with significant anticompetitive effects. *See, e.g.*, Posner, *Conglomerate Mergers and Antitrust Policy: An Introduction*, CONGLOMERATE MERGERS AND ACQUISITIONS: OPINIONS & ANALYSIS, 44 ST. JOHN'S L. REV. 529 (Special Ed. 1970).

80. *See* H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 103 (1969), 1969-3 CUM. BULL. 200, 202.

81. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 613 (codified at INT. REV. CODE OF 1954, § 385). For a penetrating discussion of the pre-1969 law regarding the debt-equity controversy see Stone, *Debt-Equity Distinctions in the Tax Treatment of the Corporation and Its Shareholders*, 42 TUL. L. REV. 251 (1968) [hereinafter cited as Stone]. Professor Stone observes:

Secretary of the Treasury to prescribe regulations to determine whether an interest in a corporation is to be treated as debt or equity;[82] (3) limitation on the use of the installment method for reporting gain on sales of realty and on casual sales of personal property;[83] (4) consistent treatment of the bondholder and the issuing corporation regarding the original issue discount;[84] and (5) limitation on corporate deductions with respect to convertible indebtedness repurchased at a premium by the corporation.[85] Section 302(a) of the Revenue Act of 1971[86] extended the limitations on use by an acquiring corporation of unused investment credits, unused work incentive credits, excess foreign tax credits, and capital losses of an acquired corporation. The 1971 provision thus restricted the use of tax losses of the acquired company to decrease the taxable income of the acquiring corporation. Although the provision was narrow in focus, it diminished the tax benefits to corporations acquiring failing corporations in a reorganization, particularly with respect to unused investment credits and capital losses.

In 1969-70, the Antitrust Subcommittee of the House Committee on the Judiciary conducted an investigation of conglomerate activity.[87] Its report confirmed the Federal Trade Commission's information on conglomerate growth,[88] and speculated that the conglomerate movement would continue to spiral into the early 1970's. Al-

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> The point is, of course, that "risk" is merely one characteristic of an equity interest. The other element, at least equally important, is the *benefit* of the equity owner's right to share in the corporation's unlimited success and growth.

Id. at 257.

82. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 613 (codified at INT. REV. CODE OF 1954, § 385). The authority granted the Treasury Secretary by INT. REV. CODE OF 1954, § 385 is permissive; the section includes guidelines which are based on prior judicial tests in determining the debt or equity nature of an instrument. *See* Stone, *supra* note 81, at 265.

83. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 412(a), 83 Stat. 608, *amending* INT. REV. CODE OF 1954, § 453(b) (codified at INT. REV. CODE OF 1954, § 453(b)(3)).

84. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 413(b), 83 Stat. 611, *amending* INT. REV. CODE OF 1954, § 1232(b)(2).

85. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 414(a), 83 Stat. 612 (codified at INT. REV. CODE OF 1954, § 249).

86. Act of Dec. 10, 1971, Pub. L. No. 92-178, § 302(a), 85 Stat. 521 (codified at INT. REV. CODE OF 1954, § 383).

87. *See generally Hearings on Conglomerate Corporations Before the Antitrust Subcomm. (No. 5) of the House Comm. on the Judiciary*, 91st Cong., 2d Sess., pts. 1-6 (1970).

88. *See generally* 1969 FTC PAPERS, *supra* note 40, at 264-313. *See also* 1969 *Tax Reform Hearings, supra* note 43, at 2386-95, 2404-28 (statements of Willard Mueller and Richard McLaren, summarizing data gathered by FTC).

though overall merger activity declined after 1969,[89] divestment of corporate divisions by corporations increased as a percentage of unification transactions.[90] The continued existence of reorganization tax exemptions was criticized in hearings before the House Ways and Means Committee in 1973,[91] but no major amendments to the reorganization provisions were enacted until 1976. Thus, despite congressional rhetorical concern with increasing industrial asset concentration, recent mergers have continued to be subsidized by the broadened merger tax exemptions.[92] The Tax Reform Act of 1976[93] did not directly address the tax merger subsidy issue. It did

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89. Corporate unification activity in the second quarter of 1970 decreased by 15 percent as compared with the same period in 1969. One factor contributing to the decline in activity may have been the inhibitive effect of the Tax Reform Act of 1969, Pub. L. No. 91-172, § 411, 83 Stat. 604 (codified at INT. REV. CODE OF 1954, § 279). The section limited interest deductions on debts incurred in financing corporate acquisitions. *See* note 142 *infra*. For a discussion of the impact of § 279 and a formulation of the role of pre-1969 tax law governing debt-financed acquisitions, see P. STEINER, MERGERS: MOTIVES, EFFECTS, POLICIES 87-95 (1975).

90. Increased sales of corporate divisions may have been stimulated by the economic climate as well as by tax advantages. The increasing inflation rate after 1969 created a shortage of capital which may have encouraged corporate divestment for needed capital. In addition, the Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 512-13, 83 Stat. 638, *amending* INT. REV. CODE OF 1954, § 1212 provided, in effect, that a company which experiences substantial losses from the sale of a business may apply such losses against capital gains that have accrued within three prior years. If a corporation qualifies for such treatment, the corporation is entitled to a tax rebate. Thus, companies which made a substantial profit on the sale of one division might save on taxes incurred if they can sell other losing divisions within the three year limitation.

91. *See Hearings on the Subject of General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 1, at 358-67 (1973) (statement of Milton D. Stewart). A major reason asserted for the "explosive rise in mergers and acquisitions of small companies by large ones" was the favorable treatment of reorganization by the Code. *Id.* at 365. A limitation on reorganization privileges to companies of a certain size was recommended as a means of insuring the continued existence of small companies in productive markets. It was further suggested that big corporations should be encouraged to "demerge" divisions which do not fit their corporate structure or sell unprofitable divisions which might be profitable in the hands of independent entrepreneurs. *Id.* at 366. It was alternatively proposed that a progressive tax based on the size of combining corporations should be levied on mergers and acquisitions. *Id.* This suggestion finds support in the ostensible theory behind the progressive rates and ability-to-pay principles of the federal tax structure. If there are economic benefits to unification, the federal government should share in those benefits by the imposition of a tax. The rationale of these proposals appears to be consistent with the present concern over industrial asset concentration. *See* Blake, *Legislative Proposals for Industrial Concentration*, in INDUSTRIAL CONCENTRATION: THE NEW LEARNING 340 (H. GOLDSCHMID, H. MANN & J. WESTON, eds. 1974).

92. *See* notes 59-68 and accompanying text *supra*.

93. *See* Act of Oct. 4, 1976, Pub. L. No. 94-455, 90 Stat. 1520.

provide restrictions on the use of loss carryovers on taxable and nontaxable acquisitions,[94] eliminating one incentive for mergers.[95]

II. Present Tax Treatment of Mergers and Other Reorganizations

For a transaction to qualify as a tax-free reorganization, it must fall within the statutory definition provided in section 368(a) of the Internal Revenue Code; statutory mergers, acquisitions by one corporation of the stock or assets of another corporation, consolidations, divisions, recapitalizations, and transactions effecting mere changes in form or place of organization are included in the definition.[96] Predominant forms of nontaxable reorganizations are: (1) statutory mergers or consolidations in which two corporations are consolidated into a new corporation;[97] (2) a mutual exchange of voting stock after which the acquiring corporation owns at least 80 percent of the voting stock of the acquired corporation and at least

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94. Act of Oct. 4, 1976, Pub. L. No. 94-455, §§ 806(a)-(b), 90 Stat. 1598.

95. *See* H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 449 (1976), U.S. Code Cong. & Ad. News 1222, 1260 (1976).

96. Int. Rev. Code of 1954, § 368(a)(1) provides that the term "reorganization" includes:

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation . . . ;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

Id. § 354 provides:

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

97. *See id.* § 368(a)(1)(A); Treas. Reg. § 1.368-2(b) (1955).

80 percent of the total number of shares of all other classes of its stock;[98] and (3) an acquisition of substantially all of the assets of the acquired corporation in exchange for the voting stock of the acquiring corporation or stock of its parent.[99] In the third form, at least 80 percent of the fair market value of the gross assets of the acquired corporation must be received; all or part of the remaining 20 percent may be cash, other property, or assumed liabilities of the acquired corporation.[100] Under present law, tax-free mergers can even be accomplished by the use of stock in a newly formed subsidiary created solely for the purpose of acquisition.[101]

In the case of a reorganization that meets the requirements of section 368, no gain or loss arising out of the exchange, except to the extent of "boot" received, will be recognized until the property is ultimately disposed of by its recipients.[102] The tax basis of property and other tax attributes of the acquired company are applied to the acquiring corporation.[103] Recognition of gain by an acquired corporation is deferred if stock is received and if any cash or other property received is distributed to the selling shareholders.[104] Exchanges of property unequal in value are generally taxable events,[105] but the sale of a business which qualifies as a reorganization is free from tax at the time of the exchange. Since this deferral is the equivalent of

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98. *See* INT. REV. CODE OF 1954, § 368(a)(1)(B).

99. *See id.* §§ 368(a)(1)(C), (2)(B).

100. *See id.* §§ 368(a)(2)(B), 357. *See also* Crockett & Kiesewetter, *Should Liabilities Assumed in Corporate Reorganizations be Tax Free? A Discussion of Congressional Policy and Judicial Interpretation,* 8 CREIGHTON L. REV. 399 (1974) [hereinafter cited as Crockett & Kiesewetter]. The Internal Revenue Service has recognized that a transaction qualifies as a tax-exempt reorganization if at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets of the acquired corporation are held by the acquiring entity immediately prior to the transfer. *See* Rev. Proc. 66-34, 1966-2 CUM. BULL. § 3.01, at 1233.

101. *See* INT. REV. CODE OF 1954, §§ 368(a)(1)(A), (D), (E). Since the inclusion of the reorganization provisions in 1918, Congress has seldom attempted to constrain their operation. *See* notes 27-29 & 52-58 and accompanying text *supra.*

102. INT. REV. CODE OF 1954, §§ 354, 361. *But see id.* § 368(a)(1)(C), permitting limited "boot" to be received. A shareholder of the acquired corporation recognizes gain only to the extent that "boot" is received from the acquiring corporation or from its parent. *See id.* §§ 354(a), 356. For the statutory treatment of liabilities assumed in connection with corporate reorganizations see *id.* § 357. *See also* Crockett & Kiesewetter, *supra* note 100, at 414-29.

103. INT. REV. CODE OF 1954, §§ 362(b), 381(c). *See id.* § 382.

104. *Id.* §§ 361(a)-(b). If cash or other property is received by the acquired corporation and not distributed to shareholders, then gain (but not loss) will be recognized up to the amount of cash or other property received. *Id.* §§ 361(b)(1)(B)-(b)(2).

105. INT. REV. CODE OF 1954, §§ 1001-02. *But see id.* §§ 1031, 1033 for the tax-free treatment of exchanges of "like property" and involuntarily converted property.

an exemption, it constitutes an immediate tax advantage, a subsidy to the acquiring corporation and its shareholders.[106]

III. Direct and Indirect Effects of the Tax Merger Subsidy

The nonrecognition provisions[107] of the current tax law are influential in planning corporate mergers;[108] they have a significant impact on the shareholders of a corporation, the corporation itself, and, indeed, even the public treasury. Thus, an examination of the subsidy's effects and the difficulties which would arise in eliminating favorable tax treatment of reorganizations will be attempted in this section.

A. *Effects on Shareholders*

The shareholder—the individual—is acutely affected by the subsidy. The main argument supporting nonrecognition of gain to shareholders in a reorganization exchange[109] is that such an exchange is purely a paper transaction, a mere change in form, not substance. Yet, when a shareholder receives publicly traded stock, a sufficient change in his economic position has occurred to justify the assessment of a tax.[110] Publicly traded stock, due to its liquidity, is sufficiently equivalent to cash for some of the securities received

106. Moreover, under the INT. REV. CODE OF 1954, § 334, if the acquiring corporation receives property in partial or complete liquidation, its shareholders may receive corporate assets with a basis equal to the fair market value at the time of the distribution, if gain or loss is recognized on the transaction. The liquidating corporation will generally recognize no gain or loss on the transaction. *Id.* § 336. Accordingly, a corporate taxpayer could escape tax altogether through the unrecognized gain resulting from a prior unifying transaction. For examples of this "equivalency of deferral with exemption" see 1 SURREY, *supra* note 1, at 413-21.

107. *See* INT. REV. CODE OF 1954, §§ 351-68, 371, 373-74.

108. *See, e.g., 1969 Tax Reform Hearings, supra* note 43, at 5493 (remarks of Edwin S. Cohen, former Assistant Secretary of the Treasury for Tax Policy).

109. *See* INT. REV. CODE OF 1954, §§ 354-58, 368.

110. When a publicly held corporation acquires a significantly smaller company, the degree of each shareholder's control may be substantially changed. The only shareholder interest not obviously altered is his investment interest, but this, too, is changed in the sense that the value of his investment changes where stock is transferred in exchange for a package of stock and securities of an acquiring corporation. Also, the newly acquired, publicly traded stock can be used as security, unlike privately held stock which is less marketable, if at all. *See* Hellerstein, *supra* note 1, at 270. Large mergers grant "a significant economic gain for shareholders of the selling enterprise." Lovett, *Tax Subsidies for Merger: Should Mergers Be Made to Meet a Market Test for Efficiency?*, 45 N.Y.U.L. REV. 844, 851 (1970) [hereinafter cited as Lovett].

to be sold to pay the tax on any gain realized on the transaction by the shareholders.[111] However, a shareholder might argue against recognizing the equivalency of stock and cash by asserting that their equivalency is lost in the process of conversion. Brokerage commissions, exchange fees, stock transfer taxes and capital gains taxes might be incurred in the sale of acquired stock. The shares received may appreciate between the time of the exchange and the time when the tax obligation becomes due. The shareholder, expecting an additional increase in value, may not wish to sell the shares to pay the taxes. Thus, if a tax were imposed on a merger or other corporate reorganization, shareholders might often be reluctant to support a proposed unifying transaction which would give them no cash to pay their tax liability. The unfairness of a tax on the merger to a small shareholder, who is unable to pay the tax without cashing in his stock, could be averted by adopting a principle found elsewhere in the Internal Revenue Code: a taxpayer who does not freely enter into a transaction should not be required to recognize gain.[112] If the merger were a taxable event, there could be an exemption for those who opposed the merger, if they reinvest the proceeds in like property within a specified period.

The problem of valuation[113] created by eliminating nonrecognition is less easily solved. When a large number of shareholders sell the shares they received in a reorganization exchange, it is possible that the rush of offerings to sell would depress the market price. Thus, if the shares had a higher value at the time of exchange than at the time of sale, each shareholder might be deprived of part of the gain for which he would be taxed. One approach to this problem might

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111. Hellerstein, *supra* note 1, at 282. To limit tax avoidance, the House proposal for the 1954 amendments to the reorganization provisions would have taxed acquisitions of companies one-fourth and above the size of the acquiring company. *See* H.R. 8300, 83d Cong., 2d Sess. §§ 359(a), (b)(2), (c)(1) (1954). *See also* M. DAVID & R. MILLER, THE LIFETIME DISTRIBUTION OF REALIZED CAPITAL GAINS, in JOINT ECONOMIC COMM., 92D CONG., 2D SESS., THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS pt. 3, at 269-84 (Comm. Print 1972).

112. Nonrecognition treatment is granted to other involuntary conversions such as insurance proceeds from fire or theft of property, or condemnation awards which are reinvested in similar property or property related in service or use. *See* INT. REV. CODE OF 1954, § 1033(a) (involuntary conversions). *See also id.* §§ 1031, 1034, 1036.

113. For a detailed discussion of valuation problems see Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967). A method of alternate valuation could be established for stocks and securities so that they could either be valued at the time of the exchange, or at a later date when their value is reasonably ascertainable. A similar method is now used by the Code in the valuation of a decedent's gross estate. *See* INT. REV. CODE OF 1954, § 2032.

be to impose a tax on the realized gain only if an adequate market exists for the sale of the stock; market value at the time of sale could be used to determine gain.[114] A significant problem with this alternative, however, is determining the existence of an adequate market. Who is to determine if an adequate market exists, and by what standards? In 1934, the Treasury Department recognized that substantial administrative problems of valuation would accompany the elimination of the reorganization provisions and did not accept the task of valuation.[115] Arguably, however, the problem of valuation is no more complex than the problem of determining which mergers meet the reorganization requirements. Indeed, the government spends substantial amounts to determine if mergers qualify for tax subsidy treatment.[116] If the nonrecognition provisions were eliminated, not only would time and expense be saved at the initial ruling stage, but also, revenues would flow into the government treasury. There may be an additional cost to the government of policing taxpayer valuation estimates occasioned by corporate acquisitions, but this would be considerably less than the sum collected in taxes on reorganizations. Moreover, the taxpayer has the first opportunity to value property, stock, or securities for tax purposes, and the antifraud provisions of Subtitle F of the Internal Revenue Code[117] would be a deterrent to the use of improper valuation methods.

Although nonrecognition appears at first blush to be beneficial to shareholders, the advantages of nonrecognition may not be as great in the case of shareholders involved in conglomerate merger activity. Individual, noncontrolling shareholders may suffer a loss of information regarding corporate worth when such mergers take place. Employment of the pooling of interest method of accounting has been particularly criticized for failing to account accurately for the cost of buying a business;[118] it arguably misleads investors. Available to conglomerates formed by an exchange of voting stock, the pooling of interest accounting method simply permits the book

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114. *See* Hellerstein, *supra* note 1, at 284.

115. *See* Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40, 42 (1969) [hereinafter cited as Cohen].

116. In 1974, $18.87 million was spent on requests for rulings and technical advice, much of which involved determining if reorganizations qualified for tax subsidy treatment. *See* 1974 COMM'R OF INT. REV. ANN. REP. 30, 50, 108.

117. *See* INT. REV. CODE OF 1954, §§ 6653(b), 7201.

118. D. EITEMAN, POOLING AND PURCHASE ACCOUNTING 141 (1967).

values of both firms to be added together.[119] Book value, however, has no direct relation to the actual market value of the firm acquired; it is the historical cost of a company's assets, not its present worth. The pooling of interest technique, therefore, suppresses the cost of acquisitions and perpetuates the distortion of true economic values. Failure of the firm to report divisional profits may also be misleading. By definition, a conglomerate is composed of many different product lines and the chance that each division performs as well as others is highly unlikely. A single earnings figure cannot possibly describe the performance of each division. Shareholders cannot realistically predict the future earnings of a diversified firm when they have access only to single earnings figures. Moreover, the reporting requirements of the Securities and Exchange Commission do not ensure that adequate information is filed at the time of the merger.[120] As a result, the shareholder is often ignorant of the actual worth of his investment in a unifying combination.

It cannot simply be concluded, however, that mergers are contrary to the shareholders' interests. While it has been asserted that the shareholders' interests are often sacrificed for the sake of artifi-

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119. *See* Gormley, *The Pooling of Interests Principle of Accounting—A Lawyer's View*, 23 Bus. Law. 407 (1968).

120. SEC Rule 133, 17 C.F.R. § 230.133 (1976), which generally exempted from registration requirements (though not from proxy statement requirements) securities issued in a statutory merger, consolidation, or asset acquisition, was rescinded, effective January 1, 1973. The "no sale" theory of Rule 133 was replaced by Rule 145, 17 C.F.R. § 230.145 (1976), which was designed to make available some of the more important informational aspects of the registration provisions of the Securities Act of 1933, 15 U.S.C. § 77g (1970), "to persons who are offered securities in a business combination." Transactions within the scope of Rule 145 include statutory mergers, consolidations or similar plans or acquisitions, and transfers of assets in connection with a plan or agreement for dissolution of a corporation. In recognition that "no one rule can adequately cover all legitimate private offers and sales of securities," Rule 146, 17 C.F.R. § 230.146 (1976), was also promulgated. It clarifies when § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d (1970), which recognizes certain exemptions from registration, is available. It is unclear how effective the new rules will be. *See* J. Weston, Regulating Transactions in Securities 97-98 (1975) (address by Ray Garrett, Jr., Chairman of the SEC, April 30, 1974).

In addition, data on conglomerate activities with respect to sales, profits, losses, and other economic and management information by "line of business" as well as information on specific product markets is inadequate. Accordingly, the government has difficulty making effective policy decisions concerning antitrust enforcement and industrial asset concentration. The Federal Trade Commission has requested that Congress fund a study of the top 500 corporations by "line of business." *See* Dalton & Penn, *Antitrust and the Snare of Published Profit Data: The Need for "Line of Business" Reporting*, 7 Antitrust Law & Econ. Rev. 75, 80 (1974).

cial growth through corporate conglomeration,[121] studies show that shareholders' returns average about the same as returns for shareholders in average-sized manufacturing units; conglomerates have a profit ratio comparable to most large firms.[122] In addition, management and shareholder interests may be well-integrated where the chief executives are the major stockholders.[123] Tax-free mergers, too, may provide immediate economic benefits to shareholders or security holders involved in unifying corporate reorganizations.[124] For example, publicly traded stock is often received for less marketable closely held stock; since gain is not recognized on the exchanges, the shareholder has an opportunity to delay selling the acquired stock until other income is low, or when other capital losses exist to offset gains.

It can be concluded that a shareholder is affected both negatively—by sustaining a loss of information—and positively—through sharing in corporate growth—by mergers encouraged by the tax subsidy. Yet, even if these consequences to shareholders offset each other, they must be assessed in light of the fact that in a tax-free exchange the shareholder receives an arguably undeserved tax benefit. The gain should not go unrecognized simply by designating the transfer as a "mere paper transaction," or because of the difficulties encountered in payment of the tax or in valuation of the property involved.

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121. The following is an example of how artificial growth is accomplished in a unifying reorganization:

> Assume Company A has a million shares earning $1 each; they are selling at $30 a share because the market judges A's growth favorably. Now assume Company B also has a million shares earning $1 each; they are selling at only $10 a share because B shows no internal growth at all. So A generously offers B's stockholders $15 a share, either in cash, which it can easily raise, or preferably in A's own stock, which has the advantage of exempting B's stockholders from an immediate capital-gains tax. In other words, A trades 500,000 of its own shares for all of B's million shares. So the new company is capitalized at 1,500,000 shares earning $2 million. This works out not to $1 a share, as before the merger, but to $1.33. Although nothing really has changed in the companies and the economy is certainly no richer, earnings per share are a third higher. On the strength of this showing, the market bids the new stock to an even higher multiple.

Burck, *The Merger Movement Rides High*, FORTUNE, Feb. 1969, at 81.

122. Weston & Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms*, in THE IMPACT OF LARGE FIRMS ON THE U.S. ECONOMY, ch. 15 (J. Weston & S. Ornstein eds. 1973). *Cf.* 1972 FTC REPORT, *supra* note 39, at 55-60.

123. W. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT 11-12 (1971).

124. *See generally* DeWind, *The Impact of Tax Factors*, 25 BUS. LAW. 765 (1970).

B. *Effects on Corporations*

Corporations enjoy a significant tax bargain in reorganizations qualifying under the present tax provisions. Prime examples of favorable treatment are the loss carryover[125] allowances in the Internal Revenue Code.[126] The carryover of net operating loss in reorganizations enables some income of the acquiring corporation completely to avoid income tax treatment. The Code limits this tax avoidance by allowing the loss carryover only to the extent that it is applied to future income from substantially the same kind of business.[127] Moreover, federal courts have developed principles to ensure that mergers follow the spirit of the Code provisions, including the continuity of interest[128] and business purpose[129] doctrines and the step-

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125. Loss carryovers are allowable business losses of the merged firms which cannot be offset by current income. INT. REV. CODE OF 1954, § 172. *See* B. BITTKER & J. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS, chs. 13, 16 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

126. *See* INT. REV. CODE OF 1954, §§ 172, 381-82. *But see id.* § 269(a), which provides that the tax benefits to a person or corporation from acquisition of control of another corporation may be disallowed where the acquisition was made for the principal purpose of income tax evasion or avoidance. The Code also authorizes the Secretary of the Treasury or his delegate to distribute, apportion, or allocate gross income, deductions, credits, or allowances among businesses controlled directly or indirectly by the same interests, if necessary to prevent tax evasion or to clearly reflect income. *Id.* § 269(b). *See also id.* § 482.

127. Under the 1954 Code a net operating loss carryover is disqualified when: (1) an increase of at least 50 percentage points occurs in the stock ownership of a corporation by a prescribed number of persons within a taxable year; (2) the increase in ownership is attributable to purchase of the stock; and (3) the corporation has not continued to carry on a business or trade substantially the same as that conducted before the change in percentage ownership of the stock occurred. INT. REV. CODE OF 1954, § 382(a). *See* Fawn Fashions, Inc., 41 T.C. 205 (1963). If, as a result of their stock ownership prior to reorganization, stockholders of the "loss corporation" do not own at least 20 percent of the fair market value of the stock of the acquiring corporation, the total net operating loss carryover from prior taxable years of the "loss corporation" is reduced. INT. REV. CODE OF 1954, § 382(b)(1). *See also* Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957); Commissioner v. Barclay Jewelry, Inc., 367 F.2d 193 (1st Cir. 1966).

The above rules have been substantially modified by the provisions of the Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 806(a)-(e), 90 Stat. 1598. Of primary importance, § 806(e) amends the limitations on net operating loss carryovers set out in INT. REV. CODE OF 1954, § 382; under the new law, the test for carryovers will no longer depend on whether the loss corporation continues in its same business or trade.

128. The continuity of interest doctrine requires that the original owners retain an interest in the reorganized corporation. This doctrine does not demand that the new corporation engage in the same or similiar business as that of its predecessor; all that is required is that there be a continuity of business activity. Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955). For a discussion of the origin of the doctrine see note 51 *supra*. *See* Tarleau, *"Continuity of Business Enterprise" in Corporate Reorganizations and Other Corporate Readjustments,* 60 COLUM. L. REV. 792 (1960).

129. A sound business purpose for the corporate acquisition is required for a transaction

transaction rule for examining the exchange.[130] Thus, a reorganization which facially meets carryover requirements may still be challenged and disqualified if the acquisition was a "sham" transaction—one in form, but not in substance. Indeed, the Supreme Court has declared:

> There is . . . no indication . . . that these provisions were designed to permit the averaging of the pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What history there is suggests that Congress primarily was concerned with the fluctuating income of a single business.[131]

The Tax Reform Act of 1976[132] restricts tax benefits from the use of loss carryovers by increasing the required percentage of ownership in the acquiring company by those who previously owned the loss company being acquired.[133] At the same time, however, the new law extends the carryover period to seven years.[134] The impact of the Act's restriction on unification activity will probably be minimal since the additional ownership interest required will not be difficult to obtain in the majority of cases. Congress itself expects negligible revenue gain from the restrictions.[135]

A company's allowable tax losses may be wasted unless the company has sufficient taxable income against which it is able to offset the losses. With a present corporate income tax rate of approximately 50 percent,[136] the after-tax rate of return can be effectively shielded by an acquired corporation's operating losses.[137] Thus, a

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to qualify as a tax-free exchange. For a discussion of the origin and essence of the doctrine see Gregory v. Helvering, 293 U.S. 465, 469 (1935).

130. All of the separate steps of the merger transaction must be examined together to see whether there has been a statutory reorganization or merely a taxable exchange. *See* Southwell Combing Co., 30 T.C. 487 (1958).

131. Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386-87 (1957).

132. Act of Oct. 4, 1976, Pub. L. No. 94-455, §§ 806(a)-(b), (d), 90 Stat. 1598.

133. Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 2d Sess., Conference Comparison on H.R. 10612 Tax Reform Act of 1976, at 28-29 (Comm. Print 1976) [hereinafter cited as Tax Reform Act of 1976].

134. Act of Oct. 4, 1976, Pub. L. No. 94-455, § 806(a), 90 Stat. 1598.

135. Tax Reform Act of 1976, *supra* note 133, at 38.

136. *See* Int. Rev. Code of 1954, § 11.

137. *See* Bittker & Eustice, *supra* note 125, ch. 16.

large tax loss carryforward is a valuable asset in a merger since it can transform taxable profits into tax-free ones. When the situation is reversed, and the acquiring corporation has losses while the firm being acquired has profits, tax advantages also accrue. The tax losses of the acquiring corporation can be combined with the profits of the acquired firm to effect overall tax savings.[138]

Another major tax incentive which may make mergers profitable for corporations is debt-equity switching.[139] When the acquiring firm exchanges debt securities for the common stock or assets of the acquired firm, the interest payments on the debentures are deductible from the income of the acquiring firm;[140] tax payments on the capital realized by the shareholders of the acquired corporation can be deferred until the debentures become due, on the theory that the transaction qualifies for installment treatment.[141] When tax deductible interest payments are substituted for nondeductible dividend payments, the cost of capital is significantly affected.[142] With interest payments, the acquiring firm pays for the stock with before-tax income; if the acquiring firm had to pay dividends on stock it issued, the dividends, since they are nondeductible, would have to come from after-tax income. Because the corporate tax rate is approximately 50 percent, the after-tax income is only half as much as the

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138. For example, Penn Central Railroad launched a major acquisition program with an estimated $500-600 million tax loss carryforward. Wall Street J., Feb. 1, 1968, at 4, col. 3. *See id.* April 17, 1968, at 15, col. 1.

139. During 1967-68, three of the 14 largest acquisitions accorded tax-free treatment under § 368 of the Internal Revenue Code involved the use of debt-equity switching. Thirteen, or nearly six percent, of the 213 large mergers occurring in 1967-68 for which tax treatment information is available, used debt-equity switching. 1969 FTC PAPERS, *supra* note 40, at 256-60.

140. *See* INT. REV. CODE OF 1954, § 163(a), providing for a deduction of "all interest paid or accrued within the taxable year on indebtedness."

141. 1969 FTC PAPERS, *supra* note 40, at 260. *See* INT. REV. CODE OF 1954, § 453.

142. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 411, 83 Stat. 604 (codified at INT. REV. CODE OF 1954, § 279), in an attempt to discourage unsound corporate financing, restricted the deductibility of interest payments of large businesses to $5 million, where the acquiring firm has a debt-to-equity ratio greater than two to one, or where the projected earnings are no larger than three times the annual interest to be paid. *See also* INT. REV. CODE OF 1954, § 385.

Section 279 may have contributed to the decline in merger activity after 1969, but it has been noted:

> Although this change in the Internal Revenue Code does eliminate the most blatant tax subsidy implicit in debt-equity switching (*i.e.*, long term deferral of capital gains), it leaves intact for *most* acquiring firms the valuable opportunity to deduct any new interest payments incurred in financing an acquisition.

Lovett, *supra* note 110, at 863.

income before taxes. Thus, the scheme permits a corporate acquisition at minimum cost and encourages the payment of a premium for the acquired firm.[143] Since the tax merger exemption lowers the tax costs of companies who sell by merger, even companies which are not incorporated may find it advantageous to incorporate their business, issue stock, and sell the stock to an acquiring firm in a tax-free exchange.[144] Companies and corporations engaging in such a transaction often receive a premium for their assets because the subsidy lowers the acquiring firm's taxes.

A corporation may also receive economic benefits because a well-planned merger makes the stock more inviting to the investor. Through flexible accounting principles, the merged industry's balance sheet and income statement may show apparent profits even though the new enterprise enjoys no increase in sales or decrease in costs.[145] The investment community may react favorably to reported increases in earnings regardless of their source and may reward the company by bidding up the price of its stock.

C. *Effects on the Economy*

Although the tax merger subsidy was created to facilitate necessary corporate readjustments in the hope of revitalizing the economy, times have changed and merger activity is no longer necessarily beneficial to the economy.[146] In 1971, an internal memorandum of the Federal Trade Commission pointed out:

> It has been estimated that if highly concentrated industries were deconcentrated to the point where the four largest firms control 40% or less of an industry's sales, prices would fall by 25% or more . . . .
>
> With prices in a highly concentrated industry at super-competitive levels, it is to be expected and is indeed the case, that profit levels will be above those found in comparable, non-concentrated industries . . . . As case studies have shown, profits in a highly concentrated industry tend to be 50% (or more) higher than in a moderately concentrated industry.[147]

143. *See* 1969 FTC PAPERS, *supra* note 40, at 256, 260-61.

144. *See* 1969 *Tax Reform Hearings, supra* note 43, pt. 7 *passim*.

145. *See* note 118 and accompanying text *supra*. *See also* 1972 FTC REPORT, *supra* note 39, at 89-97; 1969 FTC PAPERS, *supra* note 40, at 269.

146. *See* Hellerstein, *supra* note 1, at 292; Sandberg, *supra* note 12, at 98.

147. Bureau of Competition of the Federal Trade Commission, The Case for Antitrust

A study of conglomerate growth conducted by the Bureau of Economics of the Federal Trade Commission in the late sixties supports the argument that there is little justification for what is, in effect, subsidization of large corporate mergers.[148] It indicates that there exists little public benefit from industrial conglomeration in terms of increased expenditures on research and development, technological innovation, development of more efficient management techniques, increased employment, and increased capital investment by corporations and shareholders.[149] Merger activity threatens to continue to reduce the number of strong, healthy competitors in the marketplace. Levels of industrial market concentration—a relevant criterion for judging the degree of potential competition in the economy—have risen significantly. Also, there has been a steadily increasing degree of concentration of assets among fewer companies.[150] For example, in 1947, the 200 largest manufacturing corporations accounted for 47 percent of all manufacturing assets in the United States. By 1968, the figure had risen to more than 60 percent of the entire manufacturing sector of the national economy.[151] During the 1960's, a pronounced upturn in the volume of diversifying acquisitions occurred.[152] Available data suggests that the conglomerate merger wave was concentrated among a relatively small number of

Suits Against Selected Oligopoly Industries, June 11, 1971 (unpublished memorandum from the Bureau to the FTC, reproduced in Moffitt, *The Corporate Economy and the National Budget*, in THE PROBLEM OF THE FEDERAL BUDGET 9, 12 (The Study Group on the Federal Budget, Institute for Policy Studies/Transnational ed. 1975)). It should be pointed out that the FTC's memorandum refers to market concentration, as opposed to asset concentration. Conglomerate mergers directly increase the asset control of the acquiring firm, but may or may not increase market concentration, depending on the relevant line of commerce of the acquired firm. *See* C. BERRY, CORPORATE GROWTH AND DIVERSIFICATION 153 (1975).

148. *See generally* 1969 FTC PAPERS, *supra* note 40, at 262, 264-313.

149. Some economists, however, are not convinced that a conglomerate merger increases the acquiring firm's share in a given market, and argue that it has not yet been demonstrated that competition in a line of commerce or relevant market has been injured by mergers. *See* Stelzer, *Antitrust Policy and the Conglomerates,* 44 ST. JOHN'S L. REV. 196, 204 (1969). *See also* Davidow, *Conglomerate Concentration and Section Seven: The Limitations of the Anti-Merger Act,* 68 COLUM. L. REV. 1231 (1968).

150. Moffitt, *The Corporate Economy and the National Budget,* in THE PROBLEM OF THE FEDERAL BUDGET 9, 10 (The Study Group on the Federal Budget, Institute for Policy Studies/Transnational ed. 1975) [hereinafter cited as Moffitt]. *See* 1969 FTC PAPERS, *supra* note 40, at 246-47, 250-54.

151. Mueller, *The Rising Economic Concentration in America: Reciprocity, Conglomeration, and the New American "Zaibatsu" System,* 4 ANTITRUST LAW & ECON. REV. 15, 50 (1971). *See generally* 1969 *Tax Reform Hearings, supra* note 43, pt. 7, at 2363; Moffitt, *supra* note 150, at 10.

152. *See* 1972 FTC REPORT, *supra* note 40, at 61-85.

companies.[153] As a group, the 25 most active acquiring companies made acquisitions totaling $20 billion between 1961 and 1968. This represented nearly 60 percent of all the assets acquired by the top 200 acquiring corporations during the period.[154]

The loss of revenue by the Treasury as a result of the tax merger subsidy is also a major concern. The Bureau of Economics of the Federal Trade Commission has estimated that, in 1968 alone, non-assessable taxes on capital gains from 350 of the largest tax-free mergers amounted to at least several hundred million dollars.[155] Furthermore, since stockholders generally hold their shares for some time after mergers, the gain upon which they are ultimately taxed may be less than it would be immediately before the merger, when values traditionally increase. Technically, taxes on capital gains resulting from corporate reorganizations are not lost, but are deferred until the shareholder liquidates his investment in the merged enterprise.[156] Yet, even the deferral of realized gains arguably is equivalent to an interest-free government loan of the amount deferred. Given the present high interest rates, the federal government should not subsidize shareholders and their investment sales absent a showing that the public is significantly benefitted by such a subsidy.[157] Moreover, this deferral, in some cases, has amounted to a complete exemption: until recently, shareholders who died holding their investment could leave their shares to heirs who acquired a "stepped up" basis, thus avoiding all tax on the appreciation in

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153. One authority has concluded:

> The large volume of diversifying acquisitions was spread highly unevenly over the corporate population. While a scant 2 percent of all reporting companies made more than 30 diversifying acquisitions in 1961-1970, nearly two-thirds made 3 or less, and 84 percent made 8 or less.

J. MARKHAM, CONGLOMERATE ENTERPRISE AND PUBLIC POLICY 167 (1973).

154. *See* 1969 FTC PAPERS, *supra* note 40, at 272.

155. *See id.* at 256-57. The Bureau of Economics has further observed:

> It is not possible to make a precise estimate of the magnitude of capital gains accruing to shareholders of acquiring companies. However, typically the exchange value at the time of acquisition represents at least a 15 percent premium over market value prior to the announcement of the acquisition . . . . Thus, "merger created" capital gains, alone, may well have exceeded $2 billion in 1968.

Id. at 257 n.13.

156. *Id.* at 257.

157. For a taxpayer in the 60 percent tax bracket, the deferral of tax on income for 10 years excludes nearly one-half of that "income"; a 20-year deferral is equivalent to excluding 68 percent of the income. This result obtains in addition to the fact that deferral of tax amounts to an interest-free, non-recourse loan without collateral. *See* 1 SURREY, *supra* note 1, at 413-21.

value occurring before the death of the owner.[158] Under the Tax Reform Act of 1976, however, the heir acquires stock with the decedent's cost basis.[159]

The amount of revenue that has not been taxed as a result of loss carryovers is difficult to estimate. Penn Central Railroad, for example, with its estimated tax loss carryover potential of $500-$600 million, could theoretically escape paying up to $270 million in corporate income taxes.[160] Assuming a $1 billion tax loss in capital gains taxes and a loss of $2 billion in corporate income taxes as a result of tax loss carryovers, this combined loss of revenue exceeds 1.5 percent of the total revenue received by the government for the fiscal year 1969.[161] In sum, the tax merger subsidy provides a lucrative benefit to consolidating corporations at the expense of the public treasury.

Conclusion

The historical economic rationale for a tax subsidy for unifying corporations can be seen today as serving neither the public policy goals of an equitable tax structure, nor the legitimate needs of the business community. When Congress first considered and adopted the reorganization provisions, income taxes were much lower and the tax concessions afforded unifying businesses had little effect on government revenues, on the industry structure, or on the strength of competition. Indeed, the faltering economy made it "desirable to encourage flexibility in rearranging combinations of business capital."[162] Today these policy considerations are no longer viable. The corporate tax unification provisions have some influence on control of major segments of the American economy by fewer and fewer corporate entities. Too many large mergers may threaten healthy competition, distort market forces affecting industrial asset concentration, effect a serious loss of information regarding corporate wealth to shareholders and potential investors, and dangerously centralize industrial decision-making; in an age of high inflation and low employment, the impact of increased corporate unifications

158. *See* INT. REV. CODE OF 1954, § 1014.
159. Act of Oct. 4, 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1872.
160. *See* Wall Street J., April 17, 1968, at 15, col. 1.
161. *See* J. PECHMAN, FEDERAL TAX POLICY, Table C-3, at 288-89 (rev. ed. 1971).
162. Lovett, *supra* note 110, at 852. *See generally* Cohen, *supra* note 115.

on the overall performance of the economy cannot be ignored. The present existence of high income and capital gains tax rates for the sale of most business assets makes the opportunity for tax avoidance and manipulation through mergers even more unjust. Large mergers generally do represent a substantial change in business organizations, a significant economic gain for shareholders, and have an important impact upon aggregate industrial asset concentration.[163] An appraisal of these external costs of merger activity, particularly in view of the recent rapid growth of conglomerates, suggests that despite the private benefits afforded by a tax subsidy for mergers, their favorable tax treatment is unjustified and should be eliminated.

As legislative history indicates, congressional attempts in the past to deal in piecemeal fashion with the tax avoidance features of the reorganization provisions have been largely ineffective. One may reluctantly conclude that the best alternative may be to return to tax treatment prior to 1918, when mergers, acquisitions and other corporate reorganizations were examined on a case by case basis to determine whether gains would be deemed taxable events. Certainly, congressional responsibility should be assumed to insure that the tax system has a neutral effect on business decision-making, and therefore on industrial structure. All acquisitions currently covered by section 368 need not be granted tax free status; other Code provisions which serve as an incentive to acquisition need not apply to large acquiring enterprises.[164]

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163. Lovett, *supra* note 110, at 851.

164. *See, e.g.*, 1969 FTC PAPERS, *supra* note 40, at 262 (tax reform recommendations for consideration by the House Ways and Means Committee submitted by the Bureau of Economics of the Federal Trade Commission). Since heightened corporate unification activity has not accompanied the recovery of the prime interest rate, stock prices, and gross national product in the mid-seventies, it may be argued that other variables exert a greater influence on corporate decision-making than the tax subsidies for unifying corporations. Thus, an empirical study which isolates the tax variants in corporate diversification decisions and determines their relative weights should precede further recommendations for legislative action.