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Reform of the Taxation of Mergers, Acquisitions, and LBOs

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Book Review

The Merger Puzzle

Reform of the Taxation of Mergers, Acquisitions, and LBOs. By Samuel C. Thompson, Jr. Durham, N.C.: Carolina Academic Press, 1993. P. 278.

Reviewed by John A. Miller*

In tax law we generally do not question the utility and function of rules. As a matter of convenience and, perhaps, as a matter of conviction, we usually assume that law determines outcomes in a more or less linear fashion. This assumption of tax law's determinacy allows us to get on with the business of tax and with the theory of tax. If the rules are determinate, it is appropriate to consider how the rules apply to a given case and to consider whether the rules should be changed to bring about some improvement in legal outcomes. In an earlier article, I broadly defended tax law's determinacy while suggesting that we should have greater acceptance in our rule making for the inevitable role of judgment in the application of law to facts.[1] In that article I took particular note of two aspects of tax thought that can contribute to indeterminacy: the rule maker's search for "symmetry and wholeness in the law," and the planner's search for "certainty and narrow truth."[2]

Both the quest for symmetry and the quest for certainty represent legitimate efforts to define the law as it should be and as it is. But they proceed from profoundly different perspectives and often yield different outcomes. The rule maker's belief in symmetry rests on grounds of equality and neutrality.[3] Those principles exalt economic substance over outer form. Thus, for example, a bequest that serves as compensation should be taxed as compensation rather than excluded from income as a bequest.[4] The planner's belief in specificity and certainty rests upon the taxpayer's right to have notice of the law and upon her right to keep for herself so much of her

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1. John A. Miller, Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation, 68 Wash. L. Rev. 1 (1993).
2. Id. at 13.
3. See id. at 13-14 and the authorities cited therein.
4. Wolder v. Commissioner, 493 F.2d 608 (2d Cir. 1974).

property as the government has not demanded.[5] As Judge Learned Hand intoned "there is not even a patriotic duty to increase one's taxes."[6] The right to keep that which is not demanded supports technical outcomes to technical questions.

In long established areas of tax law the clash between the rule maker's quest for symmetry and the planner's quest for certainty has produced an uneasy balance. The contest continues because the parties have conflicting goals. However, both parties understand the other's moves and accept the legitimacy of certain of those moves as having been established by rule, precedent, or by long practice. After all, equality and neutrality are valid principles and so are rights to notice and to keep what has not been demanded. Thus, when the planner makes a certain move the rule maker may concede the case even though that concession may defeat the goal of economic neutrality *because the rules allow that move and force that concession.*

Nowhere in the law of taxation is the contest between the values of symmetry and certainty more refined than in the realm of corporate acquisitions. While the doctrine of substance over form has long been exalted,[7] the planner still may claim that the rules are his to manipulate.[8] In his book, Reform of the Taxation of Mergers, Acquisitions, and LBOs, UCLA law professor Samuel C. Thompson, Jr. proposes to bring a new balance to this intricate contest. It is a book written from the rule maker's perspective with an appreciation for the legitimate concerns of the planner. Professor Thompson has attempted to render coherent and evenhanded an area of tax law that traditionally has punished the ignorant and rewarded the well informed and the well heeled. He puts forward a program of reform in three areas: tax free reorganizations, taxable corporate acquisitions, and leveraged buyouts ("LBOs"). In each of these areas he proposes conservative changes that, nonetheless, taken as a whole would radically alter the current corporate tax landscape. In language as terse as the American commander's reply ("Nuts!") to the surrender request at Bastogne,[9] Professor Thompson lays out a detailed plan for an economically neutral tax policy toward mergers, acquisitions, and LBOs. He forthrightly acknowledges that "[i]t is

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5. See Miller, supra note 1, at 14 and the authorities cited therein.

6. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

7. See, e.g., Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).

8. See, e.g., Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).

9. For a brief account of the Battle of the Bulge, which included the Siege of Bastogne, see Mark Starr, Take No Prisoners, Newsweek, Apr. 29, 1985, at 20.

the purpose of this book to persuade Congress to enact the comprehensive proposals offered here" (p. 10). Whether it will have that effect remains to be seen, but there is much "offered here" that is worthy of study.

Professor Thompson possesses the credentials to justify giving him a good listen. He has served with the Treasury's tax policy office. He has practiced in the acquisitions area with a prominent Chicago-based law firm. He has taught the subject matter of this book at several distinguished law schools. He has published widely in the field of business taxation. In short, he has spent many years preparing himself for this latest undertaking. Perhaps because of this, it is no book for tax neophytes. However, for those with a grounding in the field, it is an unusually accessible and coherent treatment of the issues addressed. This is because of Professor Thompson's rigid adherence to a workable format. This format includes a consistent effort to orient the reader to the current state of the law, to describe the various proposals for reform that have been put forward previously, and then to set out Thompson's own proposals. The book is also structured so that the chapters can be read out of order without undue loss of coherence. This last feature involves some repetitiousness for the straight-through reader, but Thompson's concise and pithy writing style minimizes that discomfort.

Thompson's succinctness creates other discomforts, however. Chief among them is a tendency to state his conclusions with little underlying explanation. His authoritarian approach would be more aggravating if it were proffered by someone less competent or if it were more radical. As it is, however, the sense of certainty that Thompson conveys and the moderation of his aims tend to cause one who, like myself, is merely an interested bystander to give him the benefit of the doubt. Whether the active players in this area of tax law will be as persuaded is an open question.

The essentially conservative nature of Thompson's approach is implicit in his early announcement that "[t]his book calls for a comprehensive revision of the merger, acquisition and LBO provisions of the Code *within the context of the present classical system*" (p. 11).[10] The focus for most of his recommendations is the "stand-alone" target corporation (pp. 25-26). In general he does not propose major changes in the current law with respect to target shareholders (p. 28).[11] But, if adopted, his proposals for revision of the reorganization concept in section 368 will certainly impact them.

Thompson's position is that current law is based on correct tax policy (pp. 44-48, 54).[12] Thus, rather than abandoning the reorganization concept,

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10. Emphasis added.

11. The operative provisions for tax free reorganizations, IRC §§ 354-62, are left largely intact (pp. 68-69).

12. For example, "Congress was correct in adopting the anti-mirror legislation because unbounded deferral is fundamentally inconsistent with the concept of a corporate tax"

as others have proposed,[13] he favors reformation that renders the reorganization definition consistent and not subject to manipulation (pp. 47-48). "Parity" is the central concept of his approach to reorganizations. To that end he favors not only retention of the doctrine of continuity of interest but also extension of a uniform version of that doctrine to all types of reorganizations (including reverse subsidiary mergers). The key feature of this uniform version is the requirement that the target shareholders receive voting common stock as 80% of the consideration for their interests in the target (pp. 83-84).[14] He would bolster this version of the doctrine, which is much tougher than current law,[15] by codifying the holding in McDonald's Restaurants of Illinois, Inc. v. Commissioner (p. 77).[16] His chief justification is that "[t]he general rule that swaps of property are taxable prevents an erosion of the tax base. . . . *Nonrecognition is [only] appropriate where the taxpayer continues to have an interest in the property exchanged*" (p. 54). He is also convinced that "[c]orporate acquisitions in which a substantial part of the consideration paid is stock of the acquiring corporation are more economically desirable than transactions in which an acquisition is financed substantially with debt, such as junk bonds" (p. 56). Thompson also presses for a uniform substantially all test with exceptions only for spinoffs that satisfy section 355 (pp. 62-68).[17]

(pp. 45-46).

13. Thompson's chief foil for much of his analysis is a study draft prepared by William D. Andrews, the Reporter for the American Law Institute's Federal Income Tax Project dealing with Subchapter C of the Internal Revenue Code. William D. Andrews, Reporter's Study Draft, 1989 A.L.I. Fed. Income Tax Project (June 1).

14. He sets out five principles for this uniform doctrine. First, stock of the acquiring corporation's grandparent and great grandparent corporations will satisfy continuity of interest. Second, only voting common stock will satisfy continuity of interest. Third, 80% of the consideration for the acquisition must be such stock. Fourth, this rule should not be avoidable by means of reverse acquisitions where the actual target is the nominal acquiror. Nor should it be avoidable by means of a § 351 transaction. Fifth, there should be codification of less important rules governing which shareholders are to be counted (i.e., historic shareholders), holding periods, effect of creeping acquisitions, etc. (pp. 59-62).

15. Under current law, a straight merger requires that only 50% of the consideration received by the target shareholders take the form of equity in order to satisfy the doctrine of continuity of interest. See Rev. Rul. 66-224, 1966-2 C.B. 114. Moreover, the form of equity received need not be voting common stock. See, e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (holding nonvoting preferred stock satisfies continuity of interest).

16. See McDonald's Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982) (holding step transaction doctrine applies to post-merger dispositions of acquiror's stock by target shareholders to defeat finding of continuity of interest).

17. This proposal basically adopts Rev. Proc. 77-37, 1977-2 C.B. 568 (substantially all means 90% of net assets and 70% of gross assets). It also partially overrules Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir.), cert. denied, 305 U.S. 605 (1938) (substantially all includes target's pre-spinoff historic assets). Other than in the spinoff context Thompson's

While many aspects of his plan tighten current law, Thompson's commitment to parity also leads to several liberalizations. For example, he would eliminate the trap posed by the *Bausch & Lomb* doctrine by permitting creeping C reorganizations (p. 74).[18] Thompson also proposes to liberalize the rules with respect to transfers of the target's assets within an affiliated group (pp. 82-83). He would permit sole proprietors to incorporate for the express purpose of engaging in a tax free reorganization (pp. 91-93).[19] In addition, he would broaden the availability of post-spinoff reorganizations (pp. 88-90). And he would permit disposition of a subsidiary in a reorganization followed by a tax free distribution of the acquiring corporation's stock to the stockholders of the target's parent corporation (pp. 93-95). This last proposal would thus create parity between such a transaction and its economic twin, a section 355 spinoff followed by a nontaxable acquisition of the spinoff corporation.

Despite the fact that Thompson grounds his offerings on the laudable theme of neutrality, his proposals for tax free reorganizations will certainly strike some planners as too harsh. However, his position with respect to taxable asset acquisitions is certain to find some supporters in this same community. Thompson's view is that taxable asset acquisitions often make good sense from a business perspective,[20] and that the two tiers of tax imposed by the repeal of *General Utilities* has unduly restricted their use (pp. 97-98).[21] But even here his proposal is less generous than those of others who have written on the subject.[22] He proposes a limited carryover basis option along lines previously described by Professor George K. Yin (pp. 99-104).[23] The key feature of the proposal is that a carryover basis in the target's assets (with no target level tax) "would be available [but] only where there is an acquisition of substantially all of the [target's] assets" by a single

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substantially all test would look at the target's historic assets (p. 67).

18. See Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.) (holding that acquiror's pre-existing target stock was boot in an attempted C reorganization), cert. denied, 361 U.S. 835 (1959).

19. This reverses Rev. Rul. 70-140, 1970-1 C.B. 73.

20. The asset acquisition is the most direct route for avoiding the target's liabilities.

21. He also points out that his approach creates parity between taxable forward triangular mergers and taxable reverse triangular mergers (pp. 103-04).

22. See, e.g., Martin D. Ginsburg et al., Reexamining Subchapter C: An Overview and Some Modest Proposals to Stimulate Debate, in Corporate Tax Reform: A Report of the Invitational Conference on Subchapter C 39, 57 (George K. Yin rptr. & George Mundstock assoc. rptr., 1988).

23. See George K. Yin, Carryover Basis Asset Acquisition Regime?: A Few Words of Caution, 37 Tax Notes 415 (Oct. 26, 1987). Yin's proposal has roots in the 1989 ALI Study. For a more sweeping carryover basis proposal, see Glenn E. Coven, Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules, 44 Tax L. Rev. 145 (1989).

acquiror (p. 99). Taking a more restrictive view than Yin, Thompson would apply the substantially all test to the target's historic assets (pp. 100, 103).[24]

Another liberalizing element in Thompson's plan is an option for carryover basis (and nonrecognition) with respect to goodwill in otherwise cost basis acquisitions of stand-alone targets (pp. 110-12). As Thompson recognizes, this proposal may seem less significant with the enactment of provisions allowing for the amortization of purchased goodwill (p. 112).[25] He argues, however, that a modified version of the proposal should still be enacted because the tax cost of current gain recognition on purchased goodwill will continue to unduly limit the use of taxable asset acquisitions (p. 113).[26]

Nonrecognition with respect to goodwill is in Thompson's view simply another product of the quest for economic neutrality in the tax system between taxable stock acquisitions and taxable asset acquisitions (pp. 114-15). An extension of this policy, that planners will find less palatable, is Thompson's proposal for a mandatory section 338 election in certain stock acquisitions. He would have taxable stock acquisitions satisfy the substantially all test in order for the target to continue its basis (pp. 117-19). Otherwise a mandatory section 338 election would force the target to recognize gain. In short, taxable stock acquisitions must be like other acquisitive reorganizations except for the failure to satisfy continuity of interest. The intent is to create parity between stock and asset acquisitions. "*Carryover basis treatment applies to both types of transactions provided the substantially all test is satisfied, and if that test is not satisfied, then in both types of transactions the target corporation is subject to taxation and there is a step-up in basis for its assets*" (p. 119).

Other than the continuity of interest proposal, the proposal to extend the substantially all test may be the most controversial. One can say that in their economic substance taxable asset acquisitions and taxable stock

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24. According to Thompson, this approach is like old § 337 before the repeal of *General Utilities* without the step-up in basis. Under Yin's proposal the test would be applied to the target's assets held at the time of the acquisition. Yin, supra note 23, at 421. This would permit pre-acquisition sales of assets that would be fully taxable without affecting the validity of the carryover basis transaction.

25. The Omnibus Budget Reconciliation Act of 1993 contains such a provision. It added new § 197 to the Code which allows amortization of purchased goodwill and other intangibles over a 15-year period. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312.

26. However, at least one commentator thinks that the new provision permitting amortization of intangibles will significantly increase the number of taxable asset acquisitions. See George Brode, Jr., Structuring Taxable Acquisitions of Intangibles Under Section 197, 60 Tax Notes 1011 (Aug. 16, 1993).

acquisitions are the same.[27] But is this sufficiently true to justify this mandatory section 338 election? Consider the buyer that purchases the stock of a corporation without making any changes in its management or operations. Its purpose was simply to make a sound investment. Does such a buyer stand in the same relationship to the target's assets as the corporation that purchases those assets directly? Though we may say that the corporate shell is a fiction, it is a fiction that by long usage has become true. In a sense the fiction is dead.[28] The corporation is a real entity. If this is so, when we buy the corporation it is not the same as when we buy its property. The economic substance of a stock acquisition is a stock acquisition not an asset acquisition.[29] The form of the transaction gives it its substance.[30] Of course, in any given case this could be a close question. Often a stock acquisition is simply a mechanism for obtaining the target's assets (pp. 97-98).[31] But whether we should make this assumption the paradigm for the taxation of stock acquisitions is not obvious. However, by limiting his proposal for a mandatory section 338 election to those cases where the substantially all test is not met, Thompson's approach is sufficiently conservative to draw much of the heat from this "form as substance" argument.

In addition to addressing reform in the areas of tax free reorganizations and taxable acquisitions, Thompson addresses some concerns over the use of equity conversion transactions ("ECTs"). ECTs include both leveraged buyouts and recapitalizations where debt replaces equity. Again taking the moderate line, he proposes to limit the deductibility of interest on acquisition indebtedness in LBOs but only to the extent that the debt exceeds seventy-five percent of the acquisition price (p. 175).[32] The application of this rule would be limited to LBOs of publicly held corporations (p. 161). Similarly, his proposal for limiting the interest deduction on debt distributed to a corporation's own shareholders would only apply in the publicly held arena.

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27. See Yin, supra note 23, at 417 (noting that a stock acquisition followed by a § 332 liquidation allows the parties "to achieve indirectly the economic equivalent of a direct asset acquisition of the target without the double tax result").

28. For a fuller explanation of my meaning, see John A. Miller, Liars Should Have Good Memories: Legal Fictions and the Tax Code, 64 U. Colo. L. Rev. 1, 25 (1993).

29. Of course the same is not true of a stock acquisition that is merely a prelude to a subsidiary liquidation.

30. See Joseph Isenbergh, Musings on Form and Substance in Taxation, 49 U. Chi. L. Rev. 859, 879 (1982) (book review); Miller, supra note 1, at 37-40.

31. Thompson asserts that since the repeal of the *General Utilities* doctrine "most acquisitions of stand-alone target corporations are structured as stock purchases without a Section 338 election" (pp. 97-98). It is plain that he believes many, and perhaps most, of these acquisitions would be structured as asset acquisitions if the two levels of tax could be avoided. It is reasonable to assume that he is correct.

32. This rule will apply equally to both asset and stock acquisitions (p. 175).

The gist of this proposal is that no deduction will be allowed a publicly held corporation "for interest on debt that is directly or indirectly issued in (or in facilitation of) an extraordinary redemption or extraordinary dividend" (p. 170). Extraordinary redemptions or dividends are distributions the purpose of which is to convert equity interests into debt interests.

The justification for these limitations on the deduction of interest has several facets, but chiefly Thompson is concerned with preventing the economic harms associated with excessive leveraging. These harms include increased bankruptcies,[33] reduced research and development (pp. 148-49), and decreased efficiencies resulting from defensive ECTs.[34] His reason for limiting his proposals to publicly held corporations is that he believes acquisitions of closely held corporations promote efficiency (pp. 164-65). Credit market failures in the acquisitions of publicly held companies, Thompson asserts, was the real problem in the 1980s takeover binge (pp. 166-67).

The pencil sketch I have just offered does not do justice to the comprehensiveness of Professor Thompson's efforts to set out a new program[35] and to distinguish that program from the wealth of proposals offered by others. But at least the outlines of his proposed regime should be apparent. It is a workable plan, I think. Not too radical. Not too timid. By sticking with the present framework for tax free reorganizations, Thompson's approach has a familiar quality that may make it more salable. Yet it is a

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33. He takes particular note of the acquisition of Federated Department Stores by Campeau, Inc. and the savings and loan debacle (p. 147).

34. He takes particular note of Unocal's over-leveraging to protect itself from a takeover by Boone Pickens' Mesa Petroleum (p. 149).

35. His efforts at completeness extended to the drafting of statutory language implementing each of his proposals (pp. 256-76).

Near the end of his book, Thompson considers the impact that enactment of one of the various integration plans currently being proposed by the ALI and Treasury would have on his proposals (pp. 209-43). See Dep't of the Treasury, Report of the Department of Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once (Jan. 6, 1992); William D. Andrews & Alvin C. Warren, Jr., Tax Advisory Group Draft No. 21, Reporter's Study, 1992 A.L.I. Fed. Income Tax Project (Mar. 2). Since the publication of Professor Thompson's book ALI has issued another draft of its study. See Alvin C. Warren, Jr., Reporter's Study of Corporate Tax Integration, Integration of the Individual and Corporate Income Taxes, 1993 A.L.I. Fed. Income Tax Project (Mar. 31). Thompson argues that his reorganization proposals and the proposed interest deduction limitations would retain much of their importance. He suggests that the carryover basis proposals would largely become moot under an integration regime, as would the need for mandatory § 338 elections (p. 235). This is because with only one level of tax being imposed on taxable acquisitions in an integrated system the acquiror will prefer a step-up in basis. The reason I do not discuss this part of Thompson's book in the main text is that I do not see integration as a near-term political possibility. Of course I may be wrong in this assumption.

clear departure from the tangled jumble of confusing and often contradictory elements found in present acquisitions law. It is a lucid plan of sustained vision.

Overall, Thompson suggests, the plan should be revenue positive if enacted (p. 22).[36] In the current political climate, probably any major tax proposal would need to have this effect. The moderate assault he mounts on excessive leveraging should be acceptable to both Congress and to Wall Street. Business should be pleased with the carryover basis provisions. Who, then, would oppose its enactment into law? Those who think they have better plans, planners who have mastered all the ways to manipulate current law to the advantage of their clients, and the clients of those planners, to name a few.

Most of us would agree that economic neutrality is a desirable goal. But the question is whose version of neutrality should we adopt? Professor Thompson's conservative approach to this question represents a commendable incrementalism. By seizing upon radical ideas from a range of points of view and softening them into something that could form the basis for a consensus, he has performed a valuable service. However, law is a malleable product, and we should not expect much peace and harmony even should Professor Thompson's proposals find their way into the Code. Economic neutrality is an elusive goal not only because we don't always agree on whose paradigms to embrace, but because it is often more appealing in the classroom than in the boardroom. Planners and their clients do not go away when the old planning opportunities are shut down. They adapt. Rule makers can change the rules, but they cannot stop the contest.

36. This makes sense given the stringency of his continuity of interest test and his insistence upon a uniform substantially all test. But Thompson admits that he has made no effort at a revenue analysis (p. 235).