

Indiana Law Review

Volume 10

1977

Number 2

Taxation of Interest-on-Indebtedness in Corporate Acquisitions: An Analysis of a Congressional Response in Merger Tax Reform

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I. INTRODUCTION

In an effort to limit the federal tax subsidy for sales of corporate businesses by merger and consolidation, Congress in 1969 enacted a new statute now incorporated into the Internal Revenue Code as section 279. This provision limits the amount of deduction for interest paid on debt securities issued in connection with a corporate acquisition. In 1973 the Department of the Treasury promulgated regulations interpreting the new statute. The purpose of this Article is to determine the present relative impact of the new provision on corporate acquisitions by analyzing the most recent available data compiled by the Federal Trade Commission and by the Securities and Exchange Commission regarding current trends in corporate acquisition activity. The legislative history and operative provisions of section 279 will be discussed in detail in terms of the purpose, scope, and probable effectiveness of the section. A discussion of Treasury Department interpretation of the section will accompany the analysis of Internal Revenue Code provisions which are in some respects seemingly inconsistent with the overall legislative purpose of section 279. Finally, a suggestion is made for alteration of the section to make it more effective in neutralizing the role of tax legislation affecting corporate acquisitions.

II. HISTORICAL PERSPECTIVE

The corporate acquisition movement in the late 1960's generated serious governmental concern.¹ It was estimated that there were

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The author dedicates this article to the late Dean Richard J. Childress of St. Louis University School of Law, whose contribution to excellence in the field of legal education is exceeded only by his commitment to human equality and his outstanding ability to stimulate respect for fairness, public service, creativity, and for scholarship among his colleagues and students.

¹See [1969] FTC, ECONOMIC PAPERS 1966-1969 [hereinafter cited as ECONOMIC PAPERS]; Merger Guidelines of Department of Justice, 1 TRADE REG. REP. (CCH) ¶

4,500 merger announcements in 1968 alone,² representing an increase of 300% over the number recorded five years earlier. Similarly, in the first quarter of 1969, there were 1,432 such announcements, a 76% increase over the first quarter of 1968.³ Commentators and government officials were concerned with the possibility that if this structural transformation of American industry were allowed to continue, the country might risk serious political, economic, and social injury.⁴

A. *Economic and Tax Law Effects on Corporate Acquisitions*

The federal tax statutory scheme governing corporate acquisitions operated as a subsidy to these transactions.⁵ For example, before the enactment of section 279 one method of acquisition utilized by corporations was the purchase of stock in another corporation by transferring debt securities. Section 163 of the Internal Revenue Code permitted the acquiring corporation to deduct all of the interest on the indebtedness, and no other provision limited the deduction. It was also possible for the acquiring corporation to receive a stepped-

4510, at 6881 (Released May 30, 1968), providing that with respect to vertical mergers (acquisitions into a supplying or into a purchasing market), the Department's enforcement activity "is intended to prevent changes in market structure that are likely to lead over the course of time to significant anticompetitive consequences." *Id.* at 6885. See also S. 1167, 93d Cong., 1st Sess. (originally introduced as S. 3832, 92d Cong, 2d Sess. (1972)), 119 CONG. REC. 7320 (1973); *The Industrial Reorganization Act: Hearings on S. 1167 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 93d Cong., 1st Sess. (1973); *Report of The White House Task Force on Antitrust Policy*, reprinted in 2 ANTITRUST L. & ECON. REV. 11-52 (Winter 1968-69); *Tax Reform, 1969: Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 7 *passim* (1969) [hereinafter cited as *Hearings on Tax Reform*].

²Wall St. J., Apr. 9, 1969, at 16, col. 1.

³*Id.*

⁴See generally ECONOMIC PAPERS, *supra* note 1. This work explores the arguments and counterarguments in favor of governmental regulation of industrial concentration. See also H. GOLDSCHMID, H. MANN, & J. WESTON, INDUSTRIAL CONCENTRATION: THE NEW LEARNING (1974), a collection of economic papers exploring the relative social and economic effects of industrial concentration. The authors' view is that governmental economic concern with industrial asset and market concentration focuses primarily on the increased political and market manipulation power attendant to concentrations of private wealth. See also Burck, *The Merger Movement Rides High*, FORTUNE, February 1969, at 79 [hereinafter cited as Burck].

⁵Bittker, *Proposed legislative restrictions on acquisitions of stock by conglomerate corporations*, 30 J. TAX. 354 (1969) [hereinafter cited as Bittker]; Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40 (1969); Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957) [hereinafter cited as Hellerstein]; Sax, *The Conglomerate and Tax Reform: A Brief Review*, 25 TAX L. REV. 235 (1970) [hereinafter cited as Sax]; Thrower, *Conglomerates—Some Tax Problems*, 25 BUS. LAW. 641 (1970) [hereinafter cited as Thrower]; Crockett, *Federal Taxation of Corporate Unifications: A Review of Legislative Policy*, 15 DUQ. L. REV. 1 (1976).

up basis in the event of liquidation of the acquired company.⁶ If the acquiring corporation and the acquired corporation filed consolidated returns,⁷ intercorporate dividends might not be taxed.⁸ This type of transaction produced such a significant tax advantage that it might be described as a joint venture between the government and the acquiring corporation.

The acquired corporation and its stockholders also received tax advantages. If the acquired corporation received debt securities payable in installments, it could, under pre-1969 law, elect to defer the reporting of gain under the installment sales provisions of the Code.⁹ In some instances, this period ranged up to twenty years. The resulting deferral of the gain until either ultimate payment of the debt or sale to a third person¹⁰ had the effect of allowing many corporate acquisitions to enjoy a federal government subsidy similar to that accorded tax-free reorganizations.¹¹ Shareholders of the acquired corporation benefited from tender offers far above the market price, affording them capital gains taxed at preferential rates.¹²

⁶I.R.C. §§ 332, 334, 453. See Appert, *Installment Reporting As A Substitute For A Tax-Free Reorganization*, 22 TAX LAW. 137 (1968) [hereinafter cited as Appert]; see also Silverstein, *Impact Of The Acquisition Indebtedness Provisions Of The Tax Reform Act Of 1969 On Corporate Mergers*, 44 ST. JOHNS L. REV. 353, 367 (1970) [hereinafter cited as Silverstein].

⁷See I.R.C. §§ 1501-05.

⁸*Id.* § 243.

⁹*Id.* § 453.

¹⁰See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 14.57 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; Appert, *supra* note 6.

¹¹See I.R.C. § 368 and cross-reference provisions; see also Sandberg, *The Income Tax Subsidy To "Reorganizations,"* 38 COLUM. L. REV. 98 (1938) [hereinafter cited as Sandberg].

In addition to extending the net operating loss carryover period and restricting, somewhat, the percentage ownership requirements for qualification, section 806(e) of the Tax Reform Act of 1976 contains another significant amendment. Specifically, section 806(e) appears to eliminate the requirement of continuation of substantially the same business of the acquired entity by the acquiring entity, a provision formerly contained in section 382(a)(1)(C). Although it was probably legislative oversight, there appears to be no 1976 Act change in section 381(a)(2) which does not list reorganizations described in subparagraph (B) of section 368(a)(1); yet section 382(b)(1) of the 1976 amended Code specifically lists reorganizations described in subparagraph (B) of section 368(a)(1) as part of the group of reorganizations for which loss carryovers will be allowed. See Tax Reform Act of 1976, § 806(e), I.R.C. § 382. It thus appears that after a valiant struggle, the Libson Shops doctrine shall not be alive even in spirit. See *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957); cf. TIR 773, ¶ 55,063 P-H Fed. 1965 and Rev. Rul. 58-603, 1958-2 C.B. 147.

¹²I.R.C. §§ 1221-22, 1202.

B. *General Anatomy of a Merger Prior to 1969*

Most mergers in the recent past had similar characteristics. One was the use of so-called "funny-money" — that is, an exchange of a package of securities including debentures for stock of the target corporation to finance the acquisition.¹³ During the years 1967 and 1968, three of the eighteen largest acquisitions, involving assets of \$2 billion, included convertible debentures.¹⁴ The use of this type of security package was quite widespread. Promoters would make a public offering of convertible debentures and then use the resulting revenue to finance the acquisition of stock of the selling corporation. The use of "funny-money" led to a trend away from the transfer of acquiring company stock in effectuating a merger.¹⁵ In 1966

¹³Securities and Exchange Commissioner Budge noted that a typical exchange offer might consist of a proposal to issue a package of securities consisting of:

(1) Forty-five dollar principal amount of subordinated debentures bearing interest at a specified rate.

(2) Three-fifths of one share of preferred stock, and

(3) Three-tenths of a warrant, expiring in five years, to purchase one share of common stock at a specified price, all in exchange for two shares of common stock of a specified issuer.

Chairman Budge indicated that it may be difficult for a shareholder to evaluate the package because of the difficulty in valuing subordinated debt or preferred stock for which there is no market and for which no existing issue can be used for comparison. *Hearings on Tax Reform, supra* note 1, pt. 7, at 2368 (statement of Hamer Budge, Chairman, SEC).

¹⁴ECONOMIC PAPERS, *supra* note 1, at 260.

¹⁵*Hearings on Tax Reform, supra* note 1, pt. 7, at 2366 (Statement of Hamer Budge, Chairman, SEC). Commissioner Budge also noted that in the four years prior to 1969, the basic reasons for combinations and mergers increasingly seemed to be essentially financial. "[C]ompanies are buying other companies or merging with other companies because there are substantial immediate financial advantages to the surviving company in terms of increases in per-share earnings, and in terms of the liquid assets which can be obtained by acquiring other companies." *Id.* at 2367.

In his responses to queries by Representative Byrnes, Commissioner Budge noted that the use of convertible debentures was akin to the use of stock.

MR. BYRNES. In your experience, and from what you have seen of these operations, is there any question in your mind as to whether they [acquiring corporations] ever intend to pay cash? In redemption of the debenture, don't they anticipate that it is going to be converted into stock?

MR. BUDGE. Well, we see two movements in this area. . . .

. . . .

MR. BYRNES. But don't these proposals contemplate that when the stock exceeds the conversion price then they will then be called and the bondholder will be required to convert it into stock?

MR. BUDGE. I would guess that certainly in a great many instances it would be hoped that that would be the result.

. . . .

MR. BYRNES. I just have a feeling that that is the underlying rationale; that this would be, large part, a more or less a postponed sale of stock, in the

acquiring company stock was used in 90% of the tender offers filed with the Securities and Exchange Commission, but in 1968 the corresponding figure was only 40%.¹⁶ In 1966 there were three public issues of debt securities offered to acquire stock in the amount of \$47.8 million, but in 1968 there were thirty-one such issues for \$4.4 billion.¹⁷ Furthermore, there were fifty-four cash tender offers for stock registered with the Securities and Exchange Commission between July 29, 1968 and February 28, 1969. Approximately \$1.135 billion of the cash tender offers were financed by bank loans and \$97 million were financed by prior sales of securities.¹⁸

Mergers accomplished through the use of debt securities at times resulted in a corporate financial structure heavily burdened with debt. Arguably the use of debt securities is not improper so long as the acquiring corporation is conservatively managed with ample cash resources or low debt-equity ratios. However, this is not always the case.¹⁹ Generally a three-to-one ratio of debt to equity has been considered proper;²⁰ however, many of the acquiring companies did not have a ratio this low. In a 1967 survey of twenty-five acquiring companies, the median debt was 60% of assets, or a five-to-three debt-equity ratio.²¹

Another typical characteristic of these mergers was the tendency

interim they would be using the interest payment as a deduction, rather than paying tax on the dividend from the current issue of stock.

MR. BUDGE. I think that is correct.

MR. BYRNES. So they are really whipsawing when they call something a debt obligation that they never intended to be a debt obligation; rather, it is going to be converted into stock.

MR. BUDGE. I am sure that in a great many cases that would be the hope. It is also hoped that the price of common stock will go up.

MR. BYRNES. Once the stock price gets higher than the conversion price the corporation calls in the debenture and forces the bondholders to take the stock. This, then, is nothing other than a stock operation under the guise of a debt transaction to avoid tax liability.

Id. at 2371-72.

¹⁶*Id.* at 2366. See also Sax, *supra* note 5, at 248, for discussion of tax reform generally relative to conglomerate industry structure.

¹⁷*Hearings on Tax Reform, supra* note 1, at 2369.

¹⁸*Id.* at 2366.

¹⁹The New York Stock Exchange has delisted some securities because of excessive debt structures. N.Y. Times, Apr. 18, 1969, at 61, col. 5.

²⁰See Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971). Compare the two-to-one ratio test of section 279(b)(4)(a) with the five-to-one ratio test accepted in the international finance subsidiary area illustrated in Rev. Rul. 69-377, 1969-2 C.B. 231 and BITTKER & EUSTICE, *supra* note 10, at 4-19.

²¹*Hearings on Tax Reform, supra* note 1, pt. 7, at 2379 (SEC supplementary financial data).

to undergo a "conglomerate"²² rather than a horizontal²³ or vertical²⁴ merger. A conglomerate company is usually a group of unrelated businesses, commonly owned, which may or may not be centrally managed.²⁵ A horizontal merger is one in which a company takes over a competitor, while a vertical merger is one in which a company takes over a supplier or distributor.²⁶ Prior to the 1950 amendment to the Clayton Act, existing antitrust laws were primarily concerned with horizontal or vertical mergers,²⁷ and the agencies charged with regulating these transactions were the Federal Trade Commission and the Antitrust Division of the Department of Justice.²⁸ When conglomerate mergers became popular, governmental agencies were ill-equipped or ill-disposed to limit them.²⁹ The antitrust agencies were able to show sufficient anti-competitive effects within specific,

²²Conglomerate mergers may be of three types: (a) geographic market extension, (b) product market extension, and (c) pure or "other." For further description of these types of conglomerate merger, see ECONOMIC PAPERS, *supra* note 1, at 250. See also E. SINGER, ANTITRUST ECONOMICS 259-69 (1968) [hereinafter cited as SINGER].

²³See ECONOMIC PAPERS, *supra* note 1, at 250.

²⁴*Id.*

²⁵For a thoughtful analysis of the economic rationale for and effect of conglomerate mergers, see Edwards, *Conglomerate Bigness as a Source of Power*, in BUSINESS CONCENTRATION AND PRICE POLICY 366; SINGER, *supra* note 22, at 260.

²⁶ECONOMIC PAPERS, *supra* note 1, at 250.

²⁷Clayton Act, ch. 323, § 7, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (1970)).

²⁸The Justice Department and the FTC have promulgated guidelines indicating those mergers which are to be subject to antitrust law enforcement. See Merger Guidelines of Department of Justice, 1 TRADE REG. REP. (CCH) ¶4510, at 6881 (released May 30, 1968); see also Textile Mill Products Industry, *id.* ¶ 4535, at 6916 (FTC Release rescinded May 15, 1975); Grocery Products Manufacturing — Product Extension Mergers, *id.* ¶ 4530, at 6908 (FTC Release, May 15, 1968); Food Distribution Industries, *id.* ¶ 4525 (FTC Release, Jan. 17, 1967); Cement Industry — Vertical Mergers, *id.* ¶ 4520, at 6901 (FTC Release, Jan. 17, 1967).

²⁹See *e.g.*, Sax, *supra* note 5, at 238-39. Prior to the enactment of section 279, the Supreme Court found only a few conglomerate mergers violative of the antitrust laws, in cases in which significant anticompetitive efforts existed in narrowly defined markets. See *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967); *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963); *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962), discussed in Blake & Jones, *Toward a Three-Dimensional Antitrust Policy*, 65 COLUM. L. REV. 422 (1965); Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313 (1965).

Before the 1960's only one conglomerate merger case, involving the Ling-Tempeco-Vought, Inc. acquisition of a controlling interest in Jones & Laughlin Steel Corp., was really resolved, and that was settled by consent decree. ANTITRUST & TRADE REG. REP. (BNA) No. 467, A-1,-2 (June 23, 1970). The decree allowed LTV to retain its interest in Jones & Laughlin provided that LTV divested its interest in Braniff Airways, Inc. and in Okonite-Callender Cable Co. Hence, only partial divestiture was achieved.

relevant markets to prevent only a few conglomerate mergers.³⁰ These few challenges failed to stem the growing merger movement.

The third characteristic of conglomerate mergers during the late 1960's was the frequency of takeovers. The acquiring corporation would offer substantial prices for stock in the target corporation. The target company management could attempt to prevent a takeover by raising funds to acquire its own outstanding stock, purchasing the stock, and thus counteracting the move of the acquiring corporation. Many times this procedure was unsuccessful, either because the target company acted too late or because the funds raised were insufficient to obtain the controlling stock necessary to prevent takeover. Other target corporations, with managements eager to retain their positions, would consummate hasty and often ill-advised mergers just to save the managers' "skins." Usually an agreement would be made with the acquiring corporation to allow managers of the target corporation to retain their positions. At times, resistance by the target corporation led to a downward trend in the price of the stock and to subsequent financial ruin. Many felt that this merger warfare between corporations was not only disruptive to the target corporations, but potentially harmful to the economy as a whole.³¹ By contrast, others felt that conglomerate organization maximizes efficiency and productivity by funneling capital to enterprises which, in turn, can use the capital most profitably.³² Studies indicate, however, that most target corporations were financially healthy and growing firms³³ whose profits, when added to balance sheets of acquiring firms, generally made the acquiring firms look more profitable than before the merger. Another argument advanced by those favoring conglomerate mergers is that the conglomerate revitalizes complacent enterprises that have grown fat and sluggish in sheltered corners of the marketplace.³⁴ In addition, some take the position that conglomerate organization means a freer, more flexible, and, on the whole, a more competitive economy.³⁵

³⁰For a collection of cases in this area, see J. NARVER, *CONGLOMERATE MERGERS AND MARKET COMPETITION* (1967).

³¹ECONOMIC PAPERS, *supra* note 1, at 266-67. See also [1969] *ECON. REP. OF THE PRES.* 108.

³²Burck, *supra* note 4, at 80.

³³ECONOMIC PAPERS, *supra* note 1, at 247 n.4. For example, for the period 1948 through 1968, had the 1,202 large companies not been acquired, there would have been at least 50% more companies with assets in excess of \$10 million operating in 1968. Moreover, only 6 of the 192 "large" companies acquired in 1968 had losses in 1967. *Id.*

³⁴See Burck, *supra* note 4.

³⁵*Id.* But see ECONOMIC PAPERS, *supra* note 1, at 273-86, where it is observed: "The best available evidence argues that most large conglomerate mergers have not occurred for [reasons of managerial efficiency, creativity, research and innovation], or if they have, that they have not achieved their goals." *Id.* at 285.

The fourth characteristic of the merger movement was the "bootstrapping" feature of acquisitions. If the target firm had ample cash reserves or a relatively low debt-equity ratio, the acquiring corporation could literally finance the takeover by exchanging debt securities in its own corporation for equity in the target firm. This method of acquisition increases the acquiring firm's "leverage"³⁶ by increasing its own debt-equity ratio. The acquiring corporation's new management with its "high flying" standards would constantly seek companies with which to merge, allowing it to "leverage up." This not only gave the acquiring firm greater leverage, but also allowed it larger tax deductions for interest payments.

Richard Cheney, a public relations consultant who counseled corporations on acquisition programs, illustrated debt-equity switching in a speech:

A [firm] using subordinated debentures, convertible securities and/or warrants can afford to pay a big premium for an old line company with no debt. To get the wherewithal for his offer, all he needs is his own printing press to print the securities he is using to make his tender. And he can afford to offer a big increase in investment income to the stockholders of the target because he has the federal tax laws going for him.

He will leap at the chance to offer a \$50 debenture paying \$3 interest for a stock selling at \$40 and paying a \$2 dividend. Why not? He actually makes money in the deal. For every share of stock he gets through his tender, he makes \$2 in dividends. On this he pays only about 15 cents per share in taxes because the dividend is an intracompany dividend and the Treasury excludes 85 percent of such dividends from taxation. At the same time, the \$3 in interest he pays out is a cost of doing business for tax purposes. Each \$3 he pays out cost him only \$1.50. So he's taking in \$1.85 in dividends after taxes and paying out \$1.50 after taxes. Thus for every share he gets in his tender he makes 35 cents. He can afford to run his printing presses overtime creating funny money by the truckload.³⁷

³⁶Basically, "leverage" is the amount of borrowed funds used in making an investment. To the extent the cost of borrowed funds is less than the amount of return on the borrowed funds invested, there is an incentive for investors to use debt in making investments. Accordingly, the allowance of a tax deduction for the interest cost of borrowed funds effectively reduces the amount invested. For other examples and discussion of the leverage concept, see 1 S. SURREY, W. WARREN, P. MCDANIEL, & H. AULT, *FEDERAL INCOME TAXATION* 413-21, 416 n.18 (1972) [hereinafter cited as SURREY, ET AL.].

³⁷Address by Richard Cheney, Senior Vice-President of Hill and Knowlton, Inc., before the Ohio State Bar Association (Nov. 7, 1968), *reprinted in part in Hearings on Tax Reform, supra* note 1, at 2419.

Mr. Cheney's example is comparable to facts which were the subject of a 1968 revenue ruling on an interest deduction for the issuance of registered subordinated debentures.³⁸

III. THE GENESIS OF SECTION 279: H.R. 7489 AND SECTIONS 411-414 OF H.R. 13270

A. General Legislative Rationale

In the late 1960's an effort was made to place a check on the use of debt in corporate acquisitions. In 1969 Congressman Wilbur Mills, Chairman of the House Ways and Means Committee, issued a press release expressing consternation with the "increasing trend in recent months towards conglomerate mergers."³⁹ Mr. Mills questioned whether the welfare of the shareholders or the economy was served by permitting conglomerate mergers to continue at the then-current level. He urged companies to go slow in conglomerate mergers if they were depending upon any of the tax provisions for success of their mergers.⁴⁰ Later in 1969 Mr. Mills proposed H.R. 7489, which would have disallowed the deduction for interest paid or accrued by a corporation with respect to debt issued as consideration in connection with a plan of acquisition of stock of another corporation.⁴¹ H.R. 7489 also would have denied use of the installment method of reporting gain⁴² to sellers of shares in exchange for corporate debt issued with interest coupons or in registered form. Testimony from the Securities and Exchange Commission, the Federal Trade Commis-

³⁸See Rev. Rul. 68-54, 1968-1 C.B. 69; I.R.C. § 163. Generally, the issuance of debt constitutes an event for the recognition of gain or loss. See *LeTulle v. Scofield*, 308 U.S. 415, *rehearing denied*, 309 U.S. 694 (1940), where the taxpayer's wholly-owned corporation transferred all its assets to another corporation for cash and 10-year bonds. The Court ruled that the transfer amounted to a sale upon which gain or loss must be recognized and that the retention of a proprietary interest was not sufficient to bring the transaction within the nonrecognition provisions of the Code (the predecessors of current sections 361 and 368(a)(1)). See also I.R.C. §§ 354(a)(2), 354(b), 355(a)(3), 356(a)(2).

A valid election serves to defer the recognition of gain. *Id.* § 453. In addition, if the holder of the debt instrument were elderly and the maturity date (or the second payment date) were set sufficiently into the future, the holder's death might occur before any tax became due. While income in respect of a decedent would arise at the holder's death, the income tax deduction available to the estate could approach, equal, or exceed the benefits to be derived from date-of-death basis available to the seller had the initial shares been held for exchange in a non-taxable transaction. See *id.* § 691(a)(4); Treas. Reg. § 1.691(a)-5 (1965); Rev. Rul. 55-481, 1955-2 C.B. 279.

³⁹House Committee on Ways and Means Release, 1969, P-H ¶ 59, 501.3 (Feb. 10, 1969). See also Silverstein, *supra* note 6, at 353 n.2.

⁴⁰House Committee on Ways and Means Release, 1969 P-H ¶ 59, 501.3 (Feb. 10, 1969).

⁴¹H.R. 7489, 91st Cong., 1st Sess., 115 CONG. REC. 4210 (1969).

⁴²But see I.R.C. § 453(b).

sion, and the Justice Department supported the concept of the legislation.⁴³ Some members of the business community concerned with "takeovers" also supported the legislation. Opponents pointed out that the proposal would restrict the ability of small companies without access to the stock market to issue debt.⁴⁴

The disallowance of the interest deduction was arguably a departure from the theory of prior law, in which interest deductions had been disallowed only in those situations in which the deduction either was a "sham"⁴⁵ or was taken to avoid taxation.⁴⁶ In the "sham" cases, the courts have interpreted the term "interest" according to its common law meaning, "compensation allowed by law or fixed by the parties for the use or forbearance of money or as damages for its detention."⁴⁷ Since no valid indebtedness exists in the "sham" cases, the payment is not for the use or forbearance of money and cannot be deducted as interest.⁴⁸ In other cases, in which the debt was valid but was created for the sole purpose of avoiding federal taxes, interest deductions have been disallowed on the ground that Congress never intended section 163 to be utilized in transactions impelled solely for

⁴³Hearings on Tax Reform, *supra* note 1, pt. 7, at 2363-82, 2386-448.

⁴⁴*Id.*

⁴⁵For a discussion of the most authoritative judicial commentary justifying the elevation of substance over form in tax transactions, see *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935).

⁴⁶I.R.C. §§ 269, 482.

⁴⁷*Anna Foster*, 45 B.T.A. 126 (1941), *aff'd*, 131 F.2d 405 (5th Cir. 1942). A legatee was to receive \$75,000 income for life from trust assets consisting of stocks and bonds, which, because of financial conditions, could only be converted to cash at a large loss. The legatee and administrator agreed, therefore, to postpone distribution until the market became more favorable. Four years after the time for initial distribution, legatee received approximately \$10,000 designated as "interest" which was not included in the gross income of the legatee. Citing *Fall River Electric Light Co.*, 23 B.T.A. 168, 171 (1931), the Board ruled that interest is generally defined to be "compensation allowed by law or fixed by the parties, for the use or forbearance of money or as damages for its detention." 45 B.T.A. at 129. Thus, even though the sum in question was paid for the *detention of money* rather than for use of money, it was paid as *interest or in lieu of the income* to which legatee would have been entitled under the trust. Accordingly, the amounts were properly includible in the gross income of the legatee. For a more complete discussion of the types of transactions generating interest income, see 1 SURREY, ET AL., *supra* note 36, at 556-68.

⁴⁸In *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959), the cash method accounting taxpayer borrowed money for the purchase of treasury notes to be held as security for the loan. When the taxpayer issued checks for the payment of interest on the loan, the lender would issue another check for the same amount and receive in return the taxpayer's promissory note for the amount of interest due. The taxpayer then would deduct the amount of interest allegedly paid on his tax return for the year. The court found that the transaction was without substance and disallowed the interest deduction on the theory that there was no real liability on the part of the taxpayer.

tax avoidance.⁴⁹ Similarly, section 265(2) of the Code, which disallows deductions for interest on debt used to purchase or carry tax-exempt securities, was enacted to prevent tax avoidance. However, the fact that a person obtained a substantial economic advantage through interest deduction was not sufficient to cause disallowance.⁵⁰

The disallowance of interest deduction in H.R. 7489 was one approach to the conglomerate merger problem. The proposal, however, applied only to acquisitions of stock, exempting acquisitions of assets.⁵¹ The disallowance could occur with respect to any kind of indebtedness and would not depend on the obligation's being convertible, subordinated, or otherwise suggestive of an equity interest. There was no essential reason for preserving this distinction other than the fact that an acquisition of assets requires the imprimatur of the acquired corporation's existing management.⁵² If the management consented to a sale of assets, H.R. 7489 imposed no restriction on the acquiring corporation's use of borrowed funds or other evidence of indebtedness as consideration.⁵³ If consent were withheld, however, and the acquiring corporation appealed to the target company's shareholders over the heads of its management, the proposed legislation's disallowance of the interest deduction would have come into play.⁵⁴

Under the proposed bill the deduction for interest on indebtedness incurred by a corporation acquiring stock in another was limited only if more than 35% of the consideration for the stock consisted of evidences of indebtedness of the acquiring corporation or of other

⁴⁹See *Knetsch v. United States*, 364 U.S. 361 (1960). A taxpayer purchased an annuity contract and each year would borrow its maximum cash value, prepay interest, and execute a promissory note for the alleged loan, thereby preventing the annuity from ever building any value. In disallowing the interest deductions the Court ruled that the arrangement had no economic significance other than the generation of tax deductions contrary to the intent of Congress. See also *Rothschild v. United States*, 407 F.2d 404 (Ct. Cl. 1969), in which the court denied the interest deduction of the taxpayer because the transaction, though more than a sham, had no independent economic significance.

⁵⁰In *Commissioner v. Brown*, 380 U.S. 563 (1965), a lumber company sold its assets, valued at approximately \$1 million, to a tax exempt organization for approximately \$1.3 million. The remaining \$300,000 was considered the equivalent of interest. The Supreme Court, in a questionable opinion, upheld this characterization on the theory that the sale price roughly approximated the fair market value of the assets within a "reasonable range." Mr. Justice Harlan, however, observed that the charity obviously traded on its tax exemption. *Id.* at 580 (concurring opinion).

⁵¹H.R. 7489, 91st Cong., 1st Sess., 115 CONG. REC. 4210 (1969).

⁵²See Bittker, *supra* note 5.

⁵³See H.R. 7489, 91st Cong., 1st Sess., 115 CONG. REC. 4210 (1969).

⁵⁴*Id.*

property attributable to borrowing.⁵⁵ If such conditions were met, the bill required reduction of the acquiring corporation's deduction for interest to an amount obtained by multiplying the amount of such interest by a fraction, the numerator being 35% and the denominator being the percentage of the consideration obtained by proscribed borrowing.

B. *Inadequacies of H.R. 7489*

Some aspects of H.R. 7489 were cause for concern. Although one aim of the bill was the curtailment of abuses of the merger tax subsidies, the nature of the acquiring corporation's business or the amount of stock acquired was not taken into account. Similarly, the proposed bill would not have applied if the borrowed funds or debt securities were not used to acquire stock or if such securities constituted no more than 35% of the consideration. This 35% provision would have applied equally to large and small business acquisitions. Thus, the bill required the denial of an interest deduction if a small acquisition were accomplished by mortgaging the assets of the business to be acquired in order to pay cash to the seller.

The bill's application solely to stock acquisitions was arguably less than logical from a policy standpoint. Also a tracing problem may exist in determining whether the consideration used for acquisition is debt or other property attributable to borrowing.⁵⁶ For example, if a corporate taxpayer invests borrowed funds in equipment that is not essential to its current operations, thereby allowing unexpended cash on hand to be used for a stock acquisition, it might be difficult to attribute the consideration for the acquisition to borrowing.

The bill did not require that controlling interest in the acquired corporation be obtained before denial of the deduction. Thus, the bill would have resulted in interest deduction denial to alleged legitimate transactions not associated with tax abuses or the conglomerate merger problem. H.R. 7489 also failed to distinguish between the

⁵⁵See Sax, *supra* note 5, at 253-54, for a discussion of practical considerations involved in the 35% consideration test.

⁵⁶See, e.g., *Leslie v. Commissioner*, 413 F.2d 636 (2d Cir. 1969), in which the court disallowed a portion of an interest deduction where the taxpayer-partner in an investment house purchased and sold tax-exempt securities as part of its business, while at the same time borrowing to finance customers' purchases of securities in margin accounts. Although the tax-exempt securities were not used to secure the borrowings and the borrowed money was not "directly traceable" to the continued holding of the tax-exempt securities, the borrowing was related to the brokerage house's entire business activity which included the holding of tax-exempt securities. See also *Wynn v. United States*, 411 F.2d 614 (3d Cir. 1969).

various purposes for which corporations may seek to gain control of others. For example, the acquiring corporation may seek control of other companies solely to avail itself of tax advantages other than interest deductions, such as the tax-free liquidation of a subsidiary corporation under section 332,⁵⁷ qualification for section 1563 controlled-group surtax exemptions,⁵⁸ and section 1504 affiliated-group status for section 243 tax-free intercorporate dividends.⁵⁹

As a last major problem, the proposed bill contained no provision to avoid "creeping" acquisition, the acquiring of a target corporation through piecemeal acquisition of stock or assets.

C. H.R. 13270: The Legislative Alternative to H.R. 7489

Sections 411 through 415 of H.R. 13270, which added sections 279 and 385 to the Code,⁶⁰ were passed by the House of Representatives in lieu of H.R. 7489. While H.R. 7489 was, in some respects, too broad, its successor is arguably too narrow in that it is directed at a specific method of effecting corporate acquisitions. Instead of being directed at tax abuse generally, the section seems specifically aimed at removing a significant tax benefit, irrespective of legitimacy, from corporate acquisitions. Section 411 through 414 of H.R. 13270 contain four basic provisions affecting the use of convertible debentures in the "conglomerate merger" area.⁶¹ By its terms, section 279 is primarily directed at limiting the use of subordinated convertible debentures in corporate acquisitions and the corresponding deduction of interest payments from gross income of the acquiring corporation. The government subsidy under prior law included (a) the interest-free loan of deferred tax on gain permitted to be reported in installments by the selling shareholder, (b) taxation of gain to the selling shareholder at capital gains rates, and (c) the allowed deduction from gross income of interest payments by the issuing corporation. The convertibility feature of such securities gives them a quality similar to equity on which dividend payments would not be deductible by the issuing corporation. Another advantage, under

⁵⁷Under I.R.C. § 332, the parent corporation control requirement is 80% of all voting stock and 80% of all other classes of stock in the distributing corporation.

⁵⁸I.R.C. § 1563 requires corporate-parent control over 80% of all voting stock or control over 80% of all classes of stock for a subsidiary corporation to have status as a member of a controlled group.

⁵⁹Under I.R.C. § 1504, corporations whose common parent controls 80% of the voting stock and 80% of each class of nonvoting stock are members of an affiliated group and the intercorporate dividends received are allowed the deduction provided for in section 243.

⁶⁰H.R. 13270, 91st Cong., 1st Sess. §§ 411, 415 (1969), I.R.C. §§ 279, 385; *see also* Thrower, *supra* note 5.

⁶¹*See* text accompanying notes 74-145 *infra*.

prior law, to a corporate issuance of convertible debt instead of stock is that dividend payments reduce earnings, which amounts, if reinvested, produce revenues at the corporate internal rate of investment return; the deductibility of interest payments on debt provides an alternative means of financing where earnings are insufficient for dividend payments or for the investment required in the desired project, and where further equity dilution is undesirable. Moreover, assuming an issuance of either debt or stock in equal amounts, in order for the net gain to the corporation from stock issuance to exceed the net gain from issuance of debt, the rate of dividend payments on the stock issued must be less than one-half the interest rate payable on an equal amount of debt issued, given a corporate tax rate of approximately 50%. A corporation would not rationally issue debt paying a rate of interest higher than its capitalization rate. Thus, for a stock issuance to be attractive to either new or old shareholders, the dividend rate should be higher than the company's capitalization rate.⁶² Put formalistically: Let

G_{NE} = corporate net gain from issuance of stock;

G_{ND} = corporate net gain from issuance of an equal amount of debt securities.

The relationship of the algebraic sum of gain from each type of financing can be represented by the following equation:⁶³

$$G_{NE} - G_{ND} = r_i (1 - T^c) - r_d$$

Assuming a corporate tax rate of 50%,

$$G_{NE} - G_{ND} = \frac{1}{2} r_i - r_d$$

where:

r_i = interest rate payable on debt issued;

r_d = dividend rate on stock issued;

T^c = corporate tax rate of 50%.

Accordingly, for G_{NE} to exceed G_{ND} , $\frac{1}{2}r_i$ must exceed r_d , that is, the rate of interest payable on debt must be less than one-half the dividend rate payable on an equal amount of stock issued.

The interest deduction subsidy illustrated in the above example is not meaningfully constrained under section 279 since up to \$5 million worth of interest may be deducted without penalty.⁶⁴

⁶²Of course, a company could refrain from paying dividends altogether and reinvest these earnings at its higher internal investment rate of return. Such a policy would, however, adversely affect the price of its outstanding stock and would raise the company's overall cost of capital. For a thoughtful discussion of market reactions to alternative methods of corporate finance, see, Alberts, *The Profitability of Growth by Merger*, in *THE CORPORATE MERGER* 235-87 (W. Alberts & J. Segall ed. 1966).

⁶³The derivation of this equation appears in Appendix B. See also Statement of Hon. Hamer H. Budge, former chairman of the Securities and Exchange Commission. *Hearings on Tax Reform, supra* note 1, at 2363.

⁶⁴See notes 74-78 *infra* and accompanying text.

The debt-equity ratio test of section 279 is arguably designed to prevent corporations from assuming too high a percentage of debt obligation which assumption might cause significant losses to investors in the event of recession, high inflation, or insolvency. Another ostensible purpose of section 279 is to limit the amount of equity loss to investors who receive debt in exchange for equity in many acquisition transactions. Since acquisition of corporate assets directly has practically the same effect as acquiring the underlying corporate stock, Congress presumably felt that, as a matter of logical consistency, section 279 should also apply to debt-financed asset acquisitions.

While the House of Representatives was conducting hearings on H.R. 13270, the Treasury Department submitted proposals dealing with the use of debt in connection with corporate acquisitions.⁶⁵ Assistant Secretary for Tax Policy Edwin S. Cohen observed that H.R. 7489 had not adequately addressed the basic question existing under our tax structure whereby an interest deduction is properly disallowed only if the underlying obligation constitutes equity rather than debt. Accordingly, the Treasury proposed that the Department develop rules or regulations to aid in distinguishing debt from equity and disallow the interest deduction where the interest payments represent, in substance, a return on equity.⁶⁶ The Senate Committee on Finance heeded the proposal and recommended that H.R. 13270 be amended to incorporate the Department's suggestion.⁶⁷ This recommendation eventually became section 385 of the Code. The Treasury proposed that such rules apply whether the instrument originates as the result of an acquisition, a recapitalization, or in any other manner, and whether the company is closely held or publicly held.

⁶⁵See *Hearings on Tax Reform, supra* note 1, pt. 14, at 5380-84.

⁶⁶*Id.* at 5511-12 (statement of Hon. Edwin S. Cohen).

⁶⁷S. REP. No. 552, 91st Cong., 1st Sess., *reprinted in* [1969] U.C. CODE CONG. & AD. NEWS 2170 [hereinafter cited as S. REP. NO. 552]. Section 385(b) of the Code provides the following tests for distinguishing between debt and equity:

- (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
 - (2) whether there is subordination to, or preference over, any indebtedness of the corporation;
 - (3) the ratio of debt to equity of the corporation;
 - (4) whether there is convertibility into the stock of the corporation;
- and
- (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

To date the Treasury Department has not issued regulations pursuant to the statutory provision. Thus, case law consistent with the statutory guidelines remains intact and it is unclear what impact future Treasury regulations will have on existing court decisions. See text accompanying note 144 *infra*.

In addition, the Treasury favored the inclusion in H.R. 13270 of the rule proposed in H.R. 7489 which would deny installment sale treatment under section 453 for indebtedness issued in registered form or with interest coupons attached. The Treasury felt that these types of instruments, freely traded on the market, do not justify tax deferral. This proposal was adopted, in substance, and resulted in amendment to section 453(b) of the Code.⁶⁸ The Treasury also suggested amending section 1232 to require that original issue discount be treated as additional interest income to the bondholders, to be reported ratably over the life of the bonds. The purpose of this proposal was to achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount.⁶⁹ This proposal also was adopted.

The Senate Finance Committee also proposed some substantive changes in H.R. 13270.⁷⁰ The Committee suggested the insertion of a provision distinguishing between debt and equity consideration and proposed a debt-equity ratio test of four-to-one rather than the two-to-one ratio which subsequently prevailed. The Senate version of the bill also proposed reducing the projected earnings test from three to two times annual interest to be paid or incurred. Finally, the Senate version of the bill proposed October 9, 1969, as the effective date of section 279.⁷¹ The effective date recommendation was the only Senate Finance Committee proposal which became law.

The bill which finally emerged and was subsequently enacted into law was quite different from what Mr. Mills had originally intended. Unlike H.R. 7489, sections 411-14 of H.R. 13270 extended to asset acquisitions; partially eliminated the objection that H.R. 7489 contained no control requirement; and, by exempting the first \$5 million interest, sought to protect smaller corporations.⁷² However, by limiting the scope of the proposal, the drafters of the bill severely limited its effectiveness.⁷³ The interest deduction ceiling of \$5 million is sufficiently high to permit debt-financed acquisition of companies with significant asset size. Moreover, the statute's non-applicability to nontaxable stock acquisitions is a serious legislative omission and is directly contrary to the stated purpose of the legislation. Finally under section 279(d)(3), where control of 80% of the voting stock or of substantially all the assets of the acquired corporation is obtained, the interest on acquisition indebtedness is deductible after the year in which control is obtained and in all succeeding years. This provision

⁶⁸See I.R.C. § 453(b)(3).

⁶⁹See S. REP. NO. 552, *supra* note 67, at 146-48.

⁷⁰*Id.*

⁷¹*Id.*

⁷²See I.R.C. § 279(i).

⁷³See text accompanying notes 148-49 *infra*.

encourages control acquisitions which in turn reduce the number of independent companies, a result also contrary to the stated purpose of the legislation. In short, the statute narrows the class of debt-financed acquisitions with no interest deduction penalty to those transactions for which the legislation was supposed to limit further government subsidy.

IV. TECHNICAL EXPLANATION OF SECTION 279

Under section 279, no deduction is allowed for interest payable on securities issued after October 9, 1969, which constitutes "corporate acquisition indebtedness" to the extent such "interest"⁷⁴ exceeds \$5 million less interest on obligations to acquire stock or assets of another corporation issued after December 31, 1967, which are not "corporate acquisition indebtedness" as defined by section 279(b).⁷⁵ Thus, interest on any debt satisfying this condition which was issued after 1967 will apply to reduce the \$5 million allowable amount. The limited applicability of this provision becomes evident when it is observed that at an average interest rate of 7% a corporation can have \$70 million of indebtedness outstanding without having any exposure whatever to the disallowance.⁷⁶ Moreover, the limit applies only with respect to indebtedness incurred to buy businesses, and interest the taxpayer may pay on loans obtained for other reasons is not limited by section 279.⁷⁷

The statutory definition of corporate acquisition indebtedness and the Treasury regulations describe the conditions required for disallowing the interest deduction.⁷⁸ Corporate acquisition indebtedness is defined in section 279(b) as any corporate obligation evidenced by a bond, debenture, note, certificate, or other evidence of indebtedness issued after October 9, 1969, which satisfies the following four tests — use, subordination, convertibility, and debt-equity or interest coverage ratios.⁷⁹

A. *The Use Test*

The debt must be issued to provide consideration for the acquisition of stock or assets of another corporation; however, in the case of stock acquisition, no disallowance results unless the issuing corporation owned at least 5% of the voting power of the other

⁷⁴Treas. Reg. § 1.279-2(b)(2) (1973).

⁷⁵I.R.C. § 279(a)(2); Treas. Reg. § 1.279-1 (1973).

⁷⁶See LeFevre & Lee, *Debt or Equity, Stock Dividends, and Other Corporate Problems*, 23 TAX LAW. 511, 519 (1970).

⁷⁷*Id.*

⁷⁸I.R.C. § 279(b); Treas. Reg. § 1.279-3 (1973).

⁷⁹I.R.C. § 279(b).

corporation's stock between October 9, 1969 and the end of the year of issuance of the debt.⁸⁰ This eliminates disallowance of deductions of interest on indebtedness for "de minimis" acquisitions of stock.⁸¹ In the case of an asset acquisition, at least two-thirds of all assets (excluding money) used⁸² in the acquired corporation's business or trade must be acquired pursuant to a plan.⁸³ Section 279 also applies to acquisitions effected by exchange of stock in a wholly owned subsidiary of the acquiring corporation. For example, if X Corporation acquires all of the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.⁸⁴

B. *The Subordination Test*

The debt must be either subordinate to the claims of trade creditors of the issuing corporation generally or expressly subordinated to any substantial amount of the issuing corporation's unsecured debt. Therefore obligations subordinated to senior indebtedness, but not to trade creditors and unsecured creditors, are not covered by the statute. The test applies whether or not the unsecured debt is presently outstanding or is issued subsequent to the debt issuance's being tested.⁸⁵ The Treasury regulations provide that an obligation is expressly subordinated within the meaning of the statute if the obligation is subordinated to right of payment of any substantial amount⁸⁶ of unsecured indebtedness.⁸⁷ If the issuing corporation is a member of an affiliated group, for purposes of the subordination test, the entire group is treated as issuer.⁸⁸ The terms of subordination may be expressed in the debt instrument itself or in another agreement between the parties to the obligation.⁸⁹ Moreover:

⁸⁰*Id.* § 279(d)(5).

⁸¹S. REP. NO. 552, *supra* note 67, at 143.

⁸²For purposes of section 279(b)(1)(B), an asset which has been used in the acquired corporation's trade or business but which is temporarily not being so used shall be treated as if it is being used in such manner. Treas. Reg. § 1.279-3(b)(4)(i) (1973). This position of the Treasury seems sound from a tax policy point of view since few businesses would hold onto assets for no reason; if an asset were no longer usable, the obvious thing to do would be to sell or dispose of it in the most profitable manner.

⁸³I.R.C. § 279(b)(1)(B). Neither the statute nor the Treasury regulations indicate whether the "plan" of acquisition must be formal or if such plan may be informal.

⁸⁴Treas. Reg. § 1.279-3(b)(1)(ii) (1973).

⁸⁵I.R.C. § 279(b)(2)(B).

⁸⁶Treas. Reg. § 1.279-3(c)(2) (1973) defines "substantial amount of unsecured indebtedness" for purposes of section 279(b)(2)(B) as "[A]n amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligation issued . . ."

⁸⁷*Id.* § 1.279-3(c)(1)(ii).

⁸⁸*Id.*

⁸⁹*Id.* § 1.279-3(c)(2).

An obligation is to be considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself or in a side agreement and whether the subordination relates to interest or principle or both, but is not to be considered if the subordination occurs solely by operation of law, such as in the case of bankruptcy laws.⁹⁰

C. The Convertibility Test

The debt of a corporation which is used in the acquisition of stock or assets of another corporation, whether a bond or other evidence of debt, must be directly or indirectly convertible into stock of the issuing corporation; or the debt must be part of an investment unit consisting, in part, of an option to purchase stock of the issuing corporation. Non-convertible debt issued with stock warrants or options attached will meet this test.⁹¹ If the issuing corporation is a member of an affiliated group, the convertibility test is satisfied if the debt instrument is convertible directly or indirectly into stock of any member of the affiliated group.⁹²

D. Debt-Equity Ratio and Interest Coverage Ratio Tests

Section 279 is applicable if, as of the last day of any taxable year of the issuing corporation in which it issues⁹³ indebtedness for acquisition purposes, the issuer meets either: (1) A debt-equity test in which the ratio of the issuing corporation's debt to equity exceeds two-to-one,⁹⁴ or (2) an interest coverage test where the issuing corporation's "projected earnings"⁹⁵ are less than three times the annual interest to be paid or incurred.⁹⁶ The definitional rules for both tests are found in section 279(c); in addition the tests are to be applied on the last day of the taxable year in which any indebtedness,

⁹⁰S. REP. NO. 552, *supra* note 67, at 2171.

⁹¹*Id.* at 2172. See also I.R.C. § 279(b)(3)(B).

⁹²Treas. Reg. § 1.279-3(d)(2) (1973).

⁹³The term "issue" includes giving a note or other debt instrument to a lending institution as well as the giving of a bond or debenture. For registered securities, the date of issue is the date of the first public offering. If the securities are unregistered, the date of issue is the date the obligation is sold to the first purchaser. *Id.* § 1.279-2(b)(1).

⁹⁴I.R.C. § 279(b)(4)(A). Treas. Reg. § 1.279-5(e)(1)(ii) (1973) provides that for purposes of determining a debt-equity ratio, the term "indebtedness" is "determined in accordance with generally accepted accounting principles." The regulation lists a series of items generally considered debt, including the guarantee of the liability of another and contingent liabilities likely to become a reality. See also *id.* § 1.279-5(e)(2), Examples 1 & 2.

⁹⁵See text accompanying notes 104-06 *infra*.

⁹⁶I.R.C. § 279(b)(4)(B).

within the interest disallowance rule, is issued to acquire the stock or assets of another corporation.⁹⁷ If the debt issue escapes these tests as of the last day of the taxable year, the securities will not constitute "corporate acquisition indebtedness in succeeding years."⁹⁸ However, an exception to this rule is that the original debt, if not "corporate acquisition indebtedness" must again be tested on the last day of any subsequent year in which the issuing corporation issues more debt of any kind to acquire more stock or assets of the same corporation.⁹⁹ If on a subsequent test date the original debt satisfies the use, subordination, convertibility, and ratio tests, such debt will constitute corporate acquisition indebtedness beginning in the year ending with the subsequent test date.¹⁰⁰ Thus, care must be taken in an acquisition to guard against a disallowance of interest on a prior debt issue given in exchange for stock or assets in the same corporation.

The ratio of debt to equity is computed by comparing all of the issuing corporation's indebtedness with the sum of its money and all other assets less the indebtedness.¹⁰¹ In determining the amount of equity, the assets are taken at their adjusted basis¹⁰² and measured

⁹⁷*Id.* § 279(c)(1).

⁹⁸*See id.* §§ 279(b)(4), 279(c)(1), 279(d)(1); *see also* Tiger, *New laws "anti-conglomerate" provisions can be accommodated with proper planning*, 32 J. TAX. 130-31 (1970); Treas. Reg. §§ 1.279-5(b)(2)(i), 1.279-5(b)(3) (1973).

⁹⁹Treas. Reg. § 1.279-5(b)(2)(i) (1973) provides that if the issuing corporation is a member of an affiliated group, subsequent issuance by any other member to acquire stock of the same corporation results in a retesting of the original obligations. *See also id.* § 1.279-5(b)(4), Examples 1 & 2.

¹⁰⁰H.R. REP. NO. 413, 91st Cong., 1st Sess. pt. 1, at 105-07, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1753-55 [hereinafter cited as H.R. REP. NO. 413]; I.R.C. § 279(c)(1); Treas. Reg. § 1.279-5(b)(2) (1973).

¹⁰¹I.R.C. § 279(c)(2). Asset acquisitions may increase the liabilities of the acquiring corporation, and therefore may be less advantageous than stock acquisitions. *See* Treas. Reg. § 1.279-5(f) (1973).

¹⁰²I.R.C. § 279(c)(2). The question of whether the adjusted basis, which may be more or less than fair market value, is the appropriate value test in cases involving thin capitalization, is still unsettled. For example, in *Ainslie Perrault*, 25 T.C. 439 (1955), a partnership transferred highly appreciated assets to a newly formed corporation in exchange for cash to be repaid by the corporation in installments. If the transfer had been characterized as a reorganization under section 112(b)(5) of the 1939 Code, the corporation would have taken the shareholder's basis in the assets and the corporation's payments to the shareholders (former partners) would have constituted dividends with no interest deduction allowed to the corporation. This result would have obtained because of the high ratio of debt to equity giving the so-called corporate indebtedness, created by the transfer of the high valued assets, the characterization of capital. Instead, the Tax Court ruled the transaction a bona fide sale such that the corporation obtained as a basis in the assets the fair market value at the date of transfer. It might be of interest that Randolph Paul, a distinguished tax writer and practitioner, represented the taxpayer in *Ainslie*.

In a more blatant abuse of the reorganization basis provisions, the taxpayers in *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967), *rev'g* 239 F. Supp.

against all liabilities, short-term as well as long-term.¹⁰³

Projected earnings¹⁰⁴ are defined as the average annual earnings of the issuing corporation alone, except in situations in which the issuing corporation acquires either stock control or "substantially all the properties" of the acquired corporation.¹⁰⁵ In these situations, "projected earnings" include the average annual earnings of both the issuing corporation and the acquired corporation.¹⁰⁶

E. Control Requirement

Acquisition of "control," within the meaning of the reorganization definition of section 368(c), of "substantially all the properties" of the acquired corporation requires that the issuing corporation's earnings and interest payments be combined with those of the acquired entity in ascertaining whether the earnings and interest relationship exceeds the statutory ceiling.¹⁰⁷ This principle may be illustrated in the following example from the Treasury regulations:

Corporation X's earnings and profits calculated in accordance with section 279(c)(3)(B) for 1972, 1971, and 1970 respectively were \$29 million, \$23 million and \$20 million. The interest to be paid or incurred during the calendar year of 1973 as determined by reference to the issuing corporation's total outstanding indebtedness as of December 31, 1972, was \$10 million. By dividing the sum of the earnings and profits for the 3 years by 36 (the number of whole calendar months in the three-year period) and multiplying the quotient by 12, the average annual earnings for X Corporation is \$24 million. Since the projected earnings of X Corporation do not exceed by 3 times the annual interest to be paid or incurred

794 (D. Ore. 1965), capitalized a corporation with \$1,500 and transferred to the corporation highly appreciated logging equipment worth approximately \$200,000 in an alleged sale. To obtain money for the corporate "purchase" the shareholders (former partners and owners of the transferred assets) guaranteed the bank loan to the corporation. The corporation then deducted the interest on the loan and took as its basis in the assets, the fair market value at date of transfer. The basis provisions of section 362 were held inapplicable since the transaction amounted to a "bona fide" sale.

¹⁰³H.R. REP. NO. 413, *supra* note 100, at 105-06.

¹⁰⁴I.R.C. § 279(c)(3)(A).

¹⁰⁵Where the projected earnings test includes the earnings of both the issuing and acquired corporations,

"[S]ubstantially all of the properties" of the acquired corporation means acquisition of assets representing 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 held by the acquired corporation immediately prior to the acquisition.

Treas. Reg. § 1.279-5(d)(2)(ii) (1973).

¹⁰⁶I.R.C. § 279(c)(3)(A)(ii).

¹⁰⁷*Id.* § 279(c)(4)(B). See also Silverstein, *supra* note 6, at 376.

(they exceed by only 2.4 times), one of the circumstances described in section 279(b)(4) is present.¹⁰⁸

F. Determination of Average Annual Earnings

The "average annual earnings"¹⁰⁹ of a corporation are determined by computing the amount of its earnings and profits for any three-year period ending with the last day of the issuing corporation's tax year for which the determination is being made. The computation is made without any reduction for interest paid or incurred,¹¹⁰ allowed depreciation or amortization,¹¹¹ liability for income and related taxes,¹¹² or dividend type distributions¹¹³ other than from the acquired to the issuing corporation.¹¹⁴ Those earnings and profits are then reduced to an annual average for the three-year period pursuant to the regulations,¹¹⁵ taking into account the fact that a corporation was not in existence for the entire three-year period or for only a portion of a year within the period.¹¹⁶

G. Rules for Interest Paid or Incurred

The annual interest paid or incurred under section 279(c)(4)(A) is the issuing corporation's interest paid or incurred in a taxable year with reference to its total indebtedness outstanding.¹¹⁷ If the projected earnings include those of both issuing and acquired corporations,¹¹⁸ the annual interest to be paid or incurred is that paid by both corporations, determined by reference to their combined total indebtedness outstanding.¹¹⁹

H. Section 279 Definition of Corporate Acquisition Indebtedness

Even if debt securities are used in an acquisition, the issue will not be considered corporate acquisition indebtedness under section

¹⁰⁸Treas. Reg. § 1.279-5(e)(2), Example 1 (1973).

¹⁰⁹I.R.C. § 279(c)(3)(A); Treas. Reg. § 1.279-5(d)(3) (1973).

¹¹⁰I.R.C. § 279(c)(3)(B)(i). This approach to computation of earnings is sound legislative policy and illustrates the need for redetermination of the utility of the interest deduction generally.

¹¹¹*Id.* § 279(c)(3)(B)(ii).

¹¹²*Id.* § 279(c)(3)(B)(iii).

¹¹³*Id.* §§ 279(c)(3)(B)(iv), 301(c)(1).

¹¹⁴*Id.* § 279(c)(3)(B)(iv).

¹¹⁵Treas. Reg. § 1.279-5 (1973).

¹¹⁶I.R.C. § 279(c)(3)(B)(iv).

¹¹⁷*Id.* § 279(c)(4)(A). One possible effect of this provision might be the encouragement of corporate management to issue debt at lower interest rates especially where earnings over the three year period are expected to be low.

¹¹⁸*Id.* § 279(c)(3)(A)(ii).

¹¹⁹*Id.* § 279(c)(4)(B).

279 unless it meets all four tests in section 279(b)(1) through (b)(4).¹²⁰ If the debt does not constitute corporate acquisition indebtedness, the interest deduction is not disallowed. Debt may be corporate acquisition indebtedness not only if it is "issued as" consideration for the acquisition, but also if it is issued "to provide" consideration for the acquisition.¹²¹ The House Report indicates that if a corporation issues its obligations as considerations for a bank loan which is used to acquire stock of another corporation, or if the acquiring corporation utilizes the obligations of a related corporation to effect the purchase, such debt may be corporate acquisition indebtedness if the other conditions are met.¹²²

I. Special Rules for Banks and Finance Companies

Special rules exist for banks and lending or finance companies,¹²³ defined as entity businesses engaged in the business of "making loans or purchasing or discounting accounts receivable, notes, or installment obligations."¹²⁴ In determining the ratio of debt to equity, the corporation's indebtedness is reduced by the total amount of indebtedness owed to the company and arising out of the lending or finance business.¹²⁵ In determining the annual interest to be paid or incurred

¹²⁰See text accompanying notes 81-106 *supra*.

¹²¹I.R.C. § 279(b)(1). In defining corporate acquisition indebtedness, the regulations use the phrase "direct or indirect" consideration. Treas. Reg. § 1.279-3(b)(2) (1973). According to the Treasury, obligations are issued to provide indirect consideration for an acquisition of either stock or assets if:

(i) [A]t the time of the issuance of the obligations the issuing corporation *anticipated* the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition [at the time of the issuance], or where (ii) at the time of the acquisition the issuing corporation *foresaw* or *reasonably should have foreseen* that it would be required to issue obligations, which it would not have otherwise been *required to issue* if the acquisition had not occurred, in order to meet its future economic needs.

Id. (emphasis added). It is apparent that this regulation presents problems of intent (especially in the affiliated group context), burden of proof, reasonableness, and foreseeability. In this period of economic decline, however, litigation of these issues might be postponed, since corporations may issue up to \$5 million of debt before the statute even comes into operation.

¹²²H.R. REP. NO. 413, *supra* note 100, at 77. Obviously, corporate use of borrowed funds must be recorded in such a manner to accurately reflect the purpose of the borrowing and the relative amounts used for various projects.

¹²³I.R.C. § 279(c)(5).

¹²⁴*Id.* § 279(c)(5)(C).

¹²⁵*Id.* § 279(c)(5)(A). One possible legislative purpose for this special rule is to effectively exempt banks and financial institutions from applicability of the statute, since such a reduction all but precludes meeting the 2-to-1 debt-equity ratio test of section 279(b)(4)(A). Perhaps Congress felt interest deduction denial to acquiring financial companies would increase overall interest rates.

by a financial institution, the issuing and acquired corporation, or an affiliated group of which the corporation is a member, a portion of the interest is not taken into account — that part represented by the ratio of the amount of reduced indebtedness to the total indebtedness.¹²⁶ In determining the average annual earnings, the amount of the earnings and profits for the three-year period is reduced by the sum of the interest reductions computed under section 279(b)(5)(B).¹²⁷

The following example illustrates this principle:

As of the close of the taxable year, X Bank has a total indebtedness of \$100 million, total assets of \$115 million, and \$80 million is owed to X Bank by its customers. Bank X's indebtedness is \$20 million (\$100 million total indebtedness less \$80 million owed to the X Bank by its customers) and its assets are \$35 million (\$115 million total assets less \$80 million owed to the bank by its customers). If its annual interest to be paid or incurred is \$5 million, such amount is reduced by \$4 million:

$$\begin{array}{r}
 \$5 \text{ million interest to be} \\
 \text{paid or incurred}
 \end{array}
 \times
 \frac{\begin{array}{r}
 \$80 \text{ million owed to X} \\
 \text{Bank by its customers}
 \end{array}}{\begin{array}{r}
 \$100 \text{ million total in-} \\
 \text{edness}
 \end{array}}$$

Thus, X Bank's annual interest to be paid or incurred is \$1 million.¹²⁸

J. Taxable Years of Interest Deduction Disallowance

The fact that the interest deduction disallowance does not operate at the time the indebtedness is issued because the debt-equity or interest coverage ratio test has failed does not afford a permanent escape. Disallowance may commence with the first taxable year of issuance as of the last day of which the debt-equity or annual interest coverage test is satisfied.¹²⁹ Thereafter, under section 279(d)(2), disallowance continues even though the issuing corporation's assets

¹²⁶*Id.* § 279(c)(5)(B).

¹²⁷*Id.* § 279(c)(5)(C). In the case of affiliated groups, the rules listed above for reducing a financial institution's indebtedness, annual interest paid or incurred, or average annual earnings are taken into account with respect to the group, but the rules are not to apply to reduce the indebtedness of, annual interest to be paid or incurred by, or average earnings of, any corporation in the affiliated group which is not a bank or a lending or finance company. Treas. Reg. § 1.279-5(g)(1)(iii) (1973). Moreover, in determining whether any member of an affiliated group is primarily engaged in the lending or finance business, only the activities of such member corporation are considered. *Id.*

¹²⁸*Id.* § 1.279-5(g)(2).

¹²⁹I.R.C. § 279(d)(1); Treas. Reg. § 1.279-5(b)(2)(ii) (1973).

and earnings may have improved sufficiently to avoid classification of the debt as acquisition indebtedness.¹³⁰

K. Relief Provisions

The general rule is that once the tests prescribed by the Code are satisfied, the interest deduction on that obligation is disallowed for all subsequent years.¹³¹ However, there are exceptions to the general rule. The first applies when control of the acquired corporation is obtained.¹³² If, after the first year of disallowance, the issuing corporation acquires all the assets or obtains control of the other corporation, the completed acquisition permits the earnings and profits of both corporations to be combined and the obligation is no longer considered corporate acquisition indebtedness.¹³³ The second exception applies when the debt-equity or annual interest coverage tests are not met for three consecutive years. The disallowance is eliminated with respect to previously issued obligations for all subsequent years.¹³⁴ A third exception applies if a stock acquisition is considered "de minimis." The corporate debt will not be corporate acquisition indebtedness if at the close of the taxable year the issuing corporation owns less than 5% of the total combined voting power of all classes of stock entitled to vote in the other corporation.¹³⁵ The fourth exception applies if either of the corporations was newly formed as part of the acquisition, or if the issuing corporation acquires stock in a corporation in which it had section 368(c) control before the transaction.¹³⁶

L. Foreign Corporations and Affiliated Groups

Special rules apply to acquisition of foreign corporations and affiliated groups. An interest obligation incurred to acquire stock of a

¹³⁰See Treas. Reg. § 1.279-5(b)(4), Example 2 (1973). *But see* I.R.C. § 279(d)(4).

¹³¹I.R.C. § 279(d)(2); S. REP. NO. 552, *supra* note 67, at 142.

¹³²The inapplicability of the statute to tax free reorganization exchanges under I.R.C. § 368 is a feature which seems to be contrary to the announced purposes of section 279: preventing tax avoidance and discouraging further industrial asset concentration resulting from increased mergers and acquisitions. Under the relief provisions of I.R.C. § 279(d)(3), the allowance of a deduction for interest on transferred debt instruments in addition to nonrecognition of gain or loss on the sale of the acquired corporation would seem to invite the use of debt issuance and control acquisition where possibly neither the use of debt nor acquisition of control would be sought absent the existence of the favorable tax provisions. Accordingly, an investment or capital raising intent may be distorted into undertaking an acquisition in order to obtain the favorable tax benefits.

¹³³*Id.* §§ 279(d)(3), 279(c)(3)(A)(ii).

¹³⁴*Id.* § 279(d)(4).

¹³⁵*Id.* § 279(d)(5).

¹³⁶*Id.* § 279(e).

foreign corporation is exempt if substantially all earnings of the foreign corporation for the three years prior to the acquisition or, if shorter, the period of its existence are from foreign sources.¹³⁷

If an issuing corporation is a member of the affiliated group, the various tests are applied treating all members of the affiliated group, other than the acquired corporation, as issuer.¹³⁸ The affiliated group will be treated essentially as a single taxpayer regardless of whether a consolidated return is filed. The ratio of debt to equity, the projected earnings, and the annual interest liability of any corporation other than the actual issuing corporation are taken into account as of the particular day such other corporation was a member of the affiliated group. In determining projected earnings of an affiliated corporation other than the issuing corporation, the earnings and profits of the corporation are taken into account only for the period during which it was a member of the affiliated group. The term "affiliated group" has the same meaning as in section 1504 with the exception that the acquired corporation may not be treated as an includible corporation.¹³⁹

M. Changes in Obligation

Section 279(h)(1) provides that the extension, renewal, or refinancing of an obligation is not considered the issuance of a new obligation. Therefore, once disallowance is established, it cannot be avoided by substituting new indebtedness.¹⁴⁰ Similarly, any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation which becomes liable for the obligation as guarantor, endorser, or indemnitor, or which assumes liability for the obligation in any transaction.¹⁴¹

N. Contractual Indebtedness Existing Prior to 1969

An additional exemption is provided in section 279 for indebtedness issued after October 9, 1969 to provide consideration for

¹³⁷*Id.* § 279(f). *See id.* § 862 for rules governing determination of foreign source income. *See also* Crockett & Ashwell, *Federal Taxation of Nonresident Aliens and Foreign Corporations*, 13 DUQ. L. REV. 37, 40 (1974). The \$5 million limitation of section 279(a)(1) is reduced, however, by any interest excluded from treatment as corporate acquisition indebtedness because the proceeds are used to acquire a foreign corporation. Treas. Reg. § 1.279-3(g) (1973).

¹³⁸I.R.C. § 279(g).

¹³⁹*Id.*; Treas. Reg. § 1.279-3(b) (1973). *See id.* § 1.279-6 (1973) for required adjustments in determining basis, aggregate money, and assets of an affiliated group. The statutory and Treasury regulation treatment of affiliated groups seems to conform with ownership and control realities in this area.

¹⁴⁰I.R.C. § 279(h)(1).

¹⁴¹*Id.* § 279(h)(2).

acquisition of stock or assets. The exemption is applicable if the acquisition is made pursuant to a binding written contract in effect on October 9, 1969 and at all times thereafter before acquisition, or if the acquiring corporation owned at least 50% of the acquired corporation's stock on October 9, 1969 and at all times thereafter.¹⁴² If obligations are issued to purchase an amount of stock greater than that needed to acquire 80% control, only the proportionate part of the obligations required for the acquisition of the amount of stock necessary for control is to be eligible for this treatment.¹⁴³

O. *Effect of Issuer Designation of "Debt"*

Section 279(j) provides that designation by an issuer of an instrument as a bond, debenture, note, certificate, or other evidence of indebtedness is not controlling in applying other provisions of the Code to these instruments. Section 385 authorizes the Secretary to promulgate regulations for the determination of whether a corporate interest constitutes stock. Accordingly, Treasury regulations provide that an instrument, the interest on which is "not subject to disallowance under section 279" may constitute a stock interest under section 385, thereby resulting in disallowance.¹⁴⁴ Since a debt arises from an executed contract, it is difficult to understand how the Treasury could, prior to consummation of an acquisition agreement, give a ruling on whether an instrument is debt or equity. Assuming such a determination could be made, section 385 controls section 279 characterization and confusion is likely, especially when the nature of the obligation is changed after an initial determination has been made under section 385.¹⁴⁵ Perhaps when final regulations are issued under section 385, these questions may be resolved.

V. LEGISLATIVE INADEQUACIES OF SECTION 279

The enactment of section 279 will not, of course, remedy the inabilities of the antitrust laws to limit industrial asset concentration.¹⁴⁶ The statute's purpose is to provide less tax subsidy for corporate acquisitions.¹⁴⁷ For this purpose, the statute is arguably too narrow in scope in comparison with its proposed predecessor, H.R. 7489. In substance, section 279 has little effect on other inadequacies

¹⁴²*Id.* § 279(i).

¹⁴³S. REP. NO. 552, *supra* note 67, at 144.

¹⁴⁴Treas. Reg. § 1.279-7 (1973). Thus, a determination under I.R.C. § 385 controls the literal provisions of section 279.

¹⁴⁵See BITTKER & EUSTICE, *supra* note 10, at 4-19 & n.39.

¹⁴⁶See text accompanying notes 27-30 *supra*.

¹⁴⁷See text accompanying notes 39-41 *supra*.

of the Code which continue to provide tax subsidies for corporate acquisitions.¹⁴⁸ At best, the section constitutes a patchwork remedy and affects only taxable, noncontrol acquisitions. As long as acquiring corporations do not attempt to acquire large corporations, the acquiring firm still has the opportunity to deduct interest payments incurred in financing acquisitions of smaller companies. The so-called financial "highfliers" will still be able to deduct interest payments of up to \$5 million on "acquisition indebtedness," thereby enabling them to issue \$60 to \$70 million of debt in order to finance an acquisition.¹⁴⁹

The traditional debt vs. equity classification problem, a major issue when the legislation was passed, is not solved by the new rules of section 279; instead, the rules operate in addition to the existing case law principles and problems in this area. Section 385 provides only broad guidelines to be used by the Treasury in making a determination of what constitutes debt or equity and, unfortunately, defers to the Treasury the task of formulating a clear definition of debt and equity.¹⁵⁰ As matters now stand, arguably, a corporation can issue obligations not properly qualifying as debt and still be allowed to deduct the first \$5 million of interest.

In addition to the statute's provisions,¹⁵¹ omissions allow escape from the provisions of section 279. Since section 279(b)(2) requires the obligation to be subordinated either to claims of trade creditors or in right of payment of any substantial amount of unsecured indebtedness, the acquiring corporation could issue unsubordinated debt and thereby escape applicability of the section. Other questions are raised by the use of the term "substantial amount of unsecured indebtedness." The amount of unsecured debt may be substantial even though it constitutes a small fraction of the total debt. This point is somewhat clarified by the regulations,¹⁵² but serious doubts still remain.

The debt-to-equity ratio and projected earnings tests of section 279(b)(4) invite manipulation, since they depend upon the particular date of payment of indebtedness, earnings, and interest. Indebtedness and interest paid can be reduced by acquiring the use of

¹⁴⁸See I.R.C. § 368 and cross-referenced provisions; see also Sandberg, *supra* note 11 *passim*; Crockett, *supra* note 5.

¹⁴⁹See text accompanying note 76 *supra*. Arguably, allowing the first \$5 million of interest to be deducted, even where section 279 tests are met, is to equate the first \$5 million with the concept of shareholder equity, since such amount constitutes a continuing investment.

¹⁵⁰See text accompanying notes 56 and 67 *supra*.

¹⁵¹See text accompanying notes 131-36 *supra*.

¹⁵²Treas. Reg. § 1.279-3(c)(2) (1973). The Treasury takes the position that the term "substantial amount of indebtedness" means an amount of unsecured indebtedness equal to 5% or more of the face amount of obligations issued which constitute corporate acquisition indebtedness.

operating business assets under long-term leases rather than by purchase for debt. Indebtedness also can be reduced by payment of outstanding indebtedness shortly before the test date, although a commitment from that particular creditor to re-loan the money shortly after the test date may invite the Service to disregard the temporary reduction in indebtedness. Earnings, moreover, can be increased by any available means of accelerating income into the year ending on the test date.

VI. IMPACT OF SECTION 279 ON POST-1969 MERGER ACTIVITY

One would expect that the enactment of section 279 would have resulted in a significant decline in tax-free sales of companies in the \$80 to \$100 million asset range¹⁵³ and an increase in the number of acquisitions of smaller companies. One would also expect an increase in the use of debt securities for acquisitions of larger firms. In fact, the available data are not entirely conclusive because of the inadequacy of accurate public information concerning financial structures of the companies in question.¹⁵⁴ Nevertheless, recent

¹⁵³A company desirous of acquiring another company tax-free, and without running afoul of the \$5 million interest deduction ceiling of section 279, must satisfy two major requirements: (a) enough stock or substantially all assets must be acquired to satisfy the control requirements of section 368, and (b) the amount of interest payable on the indebtedness must not exceed \$5 million. Thus, assuming that only debt securities are issued and a 7% rate of interest, an acquiring corporation is able to stay within the \$5 million interest deduction ceiling only if it issues no more than \$70 million worth of debt. The worth of the acquired corporation usually would be limited to approximately \$87.5 million.

¹⁵⁴In studying corporate merger performance, the Federal Trade Commission lists the consideration transferred for the acquisition as either cash or securities. FTC, STATISTICAL REPORT: FEDERAL TRADE COMMISSION REPORT ON MERGERS AND ACQUISITIONS (1975) (reports are available for prior and subsequent years). Thus, it cannot be determined what proportion of the securities transferred were actually debt securities cognizable under section 279.

The annual reports of the Securities and Exchange Commission are also not very helpful in this regard, although such reports do contain the total amount of debt securities publicly issued for a given year. See 40 SEC ANN. REP. (1974).

David Penn, formerly with the Federal Trade Commission Bureau of Economics, and James Dalton, economics professor at Southern Illinois University, have observed, generally, that data about corporate finances available to researchers from the usual public sources are highly unreliable and, indeed, misleading in a number of important respects. See Dalton & Penn, *Antitrust and the Snare of Published Profit Data: The Need for 'Line-of-Business' Reporting*, 7 ANTITRUST L. & ECON. REV. 75, 77 (1974).

The Bureau of Economics of the Federal Trade Commission, in noting the effect of conglomerate expansion, recognized that the loss of financial information is of potentially serious consequence to investors, to policymakers, and upon the sufficient functioning of capital markets. See FTC ECONOMIC REPORT-CONGLOMERATE MERGER PERFORMANCE: AN EMPIRICAL ANALYSIS OF NINE CORPORATIONS 87 (1972) [hereinafter cited as EMPIRICAL ANALYSIS OF NINE CORPORATIONS].

Federal Trade Commission data compilations¹⁵⁵ for the years 1969 through 1974 indicate the following trend:

Year	Number of Acquisitions	Assets ^a Millions
1969	136	10,996.2
1970	90	5,876.0
1971	58	2,443.4
1972	58	1,860.3
1973	64	3,148.8
1974 ^b	62	4,471.3

a/ Acquired firms with assets of \$10 million or more.

b/ Figures for 1974 are preliminary.

The above tabulation does not include companies for which data were not publicly available. There were 346 such companies with assets of \$8,161.2 million for the period 1948-1974.

The above tabulation indicates that the sharp decline in merger activity occurring immediately after 1969 has reversed. This behavior might be explained by the fact that merger activity tends to parallel periods of economic growth and recession. Significant events in 1969-70 included the Cambodian invasion, the Penn-Central bankruptcy, and the Laos invasion. After a sharp drop in stock averages, the market began to climb only to be met by the wage-price freeze. Following a slight decline, stock averages reached a record high between 1972 and 1973. The Nixon resignation and the American Telephone and Telegraph antitrust suit paralleled another sharp drop in stock averages in 1974. At the time of this writing we are witnessing an overall recovery in stock averages. Thus, there are many factors contributing to corporate merger activity which have little to do with the provisions of a given tax statute and, as much as possible, the analyst must take into account as many variables as available data permit.

In 1974, 3.6% of the total assets acquired through merger involved companies in the \$50 to \$100 million-plus asset range.¹⁵⁶ Accurate percentage figures for the year 1973 are not available; however, assets acquired in 1974 were 42% higher than in 1973, indicating that on the average much larger companies were acquired in 1974 than in 1973.¹⁵⁷ In 1972, 1.4% of the total assets acquired through merger

¹⁵⁵[1975] FTC STAT. REP. ON MERGERS & ACQUISITIONS 112, Table 12 [herein-after cited as [1975] FTC REP.].

¹⁵⁶*Id.* at 17, Table 7.

¹⁵⁷*Id.* at 109.

involved companies in the \$50 to \$100 million asset range.¹⁵⁸ These data tend to suggest that section 279 is having a limited impact upon large mergers in recent years. It should also be noted, however, that between 1972 and 1974 roughly 75% of all merger activity involved the acquisition of companies with assets of less than \$1 million.¹⁵⁹

One possible impact of section 279 might be the recognized efforts of corporations to improve their debt-equity ratios.¹⁶⁰ However, this effort did not begin until 1971, two years after the enactment of section 279. In addition, Securities and Exchange Commission registration data are inconclusive since rule 146 fails to effectively limit use of a method for corporations to avoid the registration requirement of rule 145, with the result that there is no information regarding the dollar amount and type of security involved in many mergers.¹⁶¹ The Securities and Exchange Commission's 1973 data indicate, however, that securities registered for other than cash sales, primarily in connection with mergers and consolidations, rose substantially, reflecting the new registration requirement.¹⁶² Since rule 145 did not become effective until January 1973, further analysis of a comparison of debt and equity issued in connection with mergers must be postponed until sufficient data have been compiled.

¹⁵⁸[1973] FTC STAT. REP. ON MERGERS & ACQUISITIONS 3, Table 6 [hereinafter cited as [1973] FTC REP.]. This figure, unlike the comparable figures for 1973 and 1974, involves only completed mergers. The figure for completed and pending mergers would be slightly higher. For example, for pending mergers in 1972, 2.5% of the companies to be acquired had assets in size ranging from \$50 to \$100 million-plus.

¹⁵⁹The actual figures for the percentage of mergers involving the acquisition of companies with asset sizes under \$1 million for 1972 through 1974 are: 78.3% for 1974, [1975] FTC REP., *supra* note 155, at 17, Table 7; 82.2% for 1973, [1974] FTC STAT. REP. ON MERGERS & ACQUISITIONS 15, Table 7; 73.9% [1973] FTC REP., *supra* note 158, at 3, Table 6. It should be noted that in 1972 the data on mergers included separate figures for completed and pending mergers. For 1973 and succeeding years, the data included combined figures for completed and pending mergers.

¹⁶⁰In its Annual Report the Securities and Exchange Commission observed that, although there were 3,712 registration statements declared effective in 1972 compared with the previous record number of 3,645 effective registration statements for 1969, the total dollar amount in 1972 fell far short of the record \$82.5 billion set in 1969. The Commission noted also that there had been steady decline in the dollar value of equity issues between 1969 and 1972 but a steady increase in the dollar value of debt issues. However, since 1972 there has been a much greater decline in the value of debt issued for cash sale compared with equity issues. See 38 SEC ANN. REP. 163-66 (1972).

¹⁶¹See generally *id.* at 13 for an explanation of the purpose and limitations of rule 145. For an explanation of how the rule is intended to interact with rule 146, see Address by Ray Garrett, Jr., Chairman of Securities and Exchange Commission (April 30, 1974), reprinted in J. WIESEN, REGULATING TRANSACTIONS IN SECURITIES: THE EXPANDING IMPACT ON CORPORATE MANAGERS, INVESTORS AND THE FINANCIAL COMMUNITY 97-99 (1975).

¹⁶²39 SEC ANN. REP. 165 (1973).

Given the present level of industrial asset concentration,¹⁶³ it would seem that within the next few decades not many healthy, growing firms will remain to be acquired. Thus, the use of debt in corporate acquisitions will necessarily decline with the overall decline in merger activity. Preliminary indications, however, are that the use of registered debt securities in mergers and acquisitions is increasing, at least it was between the years 1973 and 1974. The Securities and Exchange Commission data indicate that debt securities constituted roughly 2.6% of the total \$10.5 billion securities issued for other than cash sale in 1973.¹⁶⁴ For fiscal year 1974, the percentage of debt securities constituted roughly 12.5% of a total \$12.2 billion securities issued for other than cash sale.¹⁶⁵ Although not indicative of the amount of debt issued in an actual acquisition, the data suggest that section 279 is not significantly thwarting the use of debt in corporate mergers and acquisitions.

VII. CONCLUSION

Congress should reconsider its responsibility to reduce tax inequities inherent in the Code and should repeal present tax subsidies for corporate acquisitions and other transactions which are not in the public or corporate business interest.¹⁶⁶ It is submitted that corporations and shareholders are not benefited by the decline of competition occasioned by the increased industrial asset concentration resulting from tax-subsidized corporate unifications.¹⁶⁷ Greater industrial asset concentration dictates greater governmental regulation which is counter to the concept of free enterprise and entrepreneurial opportunity.

The \$5 million interest deduction ceiling of section 279 effectively exempts many transactions from applicability of the statute. Perhaps the most serious defect in section 279 is its failure to define "equity"

¹⁶³The 500 largest nonfinancial corporations in the United States control 65% of all sales, 79% of all profits, and employ 76% of all workers engaged in manufacturing. Malley, *The Fortune Directory of the 500 Largest Industrial Corporations*, FORTUNE, May 1974, at 231. See also STUDY GROUP ON THE FEDERAL BUDGET, INSTITUTE FOR POLICY STUDIES TRANSNATIONAL, THE PROBLEM OF THE FEDERAL BUDGET (1975), for a thoughtful analysis and discussion of the spending and taxing distortions built into the federal taxation and budgetary process resulting in the increased disparity of economic benefits among individuals and enterprises.

¹⁶⁴39 SEC ANN. REP. 165, Table 22 (1973).

¹⁶⁵40 SEC ANN. REP. 169, Table 21 (1974).

¹⁶⁶See SURREY ET AL., *supra* note 36, at 239-99, 341-495, and authorities therein cited; see also Hellerstein, *supra* note 5, at 256.

¹⁶⁷See, e.g., EMPIRICAL ANALYSIS OF NINE CORPORATIONS, *supra* note 154; J. BUTTERS, J. LINTER, & W. CARY, EFFECTS OF TAXATION: CORPORATE MERGERS (1951). Compare H. GOLDSCHMID, H. MANN, & J. WESTON, INDUSTRIAL CONCENTRATION: THE NEW LEARNING (1974).

and "debt" for purposes of the statute.¹⁶⁸ An opportunity to squarely face this issue has again been postponed.

Section 279 may, however, provide some deterrence to the use of "debt" securities in acquisitions of large companies. More study is required to determine whether the statute has been a significant factor in the decline of mergers since its enactment.¹⁶⁹ It should be noted, however, that were the use of debt securities in mergers proscribed altogether, firms could resort to the use of other types of securities such as preferred stock, warrants, convertible preferreds, or some combination of any of these. Nevertheless, section 279 does lessen somewhat the tax abuse potential of debt instrument transfers in the corporate merger area.

The major weakness of the statute is its inapplicability, one year after issuance, to tax-free and taxable acquisitions where control is obtained, since these transactions are most likely to include issuance of debt instruments. Accordingly, paragraph 279(d)(3) and subsection 279(e) should be repealed by Congress as inconsistent with the purposes of the statute and as inconsistent with present congressional concern with the adverse political and economic effects of industrial asset concentration in critical markets.¹⁷⁰

¹⁶⁸One can imagine the litigation problems apparent from an inconsistent definition of "debt" for purposes of sections 279 and 385. See text accompanying notes 144-45 *supra*.

¹⁶⁹One significant factor, however, influencing the decline of corporate unifications might be the 1969 amendment to I.R.C. § 1212 allowing corporations selling stock in their poorly performing divisions and subsidiaries to carry back such capital losses as an offset against the prior three years' capital gains. In fact, sales of divisions during the first half of 1970 constituted 33% of all mergers during the same period, a two-fold increase from the amount of such sales in 1969. See Ulin, *Environment for Divestment* in *TECHNIQUES IN CORPORATE REORGANIZATION* 9-11 (W. Mishkin ed. 1972). Accordingly, post-1969 corporate diversification activity indicates a primary motivation on the part of corporate management to maximize profits and internal investment rates of return. Further empirical and formalistic inquiry is necessary to determine more accurately the relative impact of the tax laws on corporate profits and rates of return for given forms of diversification. Appendix A describes corporate and shareholder profit maximization decision models, both of which include the significant tax variants applicable in a diversification decision. Each model, when applied to the various forms of diversification, would provide additional information regarding the actual financial impact of tax variants. See Appendix A.

It is likely, moreover, that section 1212 would have more impact on management financial decision-making than section 279, especially during periods of recession when stock prices decline, interest rates rise, and management seeks investment at the lowest cost; a nontaxable capital loss refund, which is accommodated in equation (6) of Appendix A, is a most attractive source of capital under such economic conditions.

¹⁷⁰See Senator Philip Hart's proposed Industrial Reorganization Act, S. 3832, 92d Cong., 2d Sess., 118 CONG. REC. 24928 (1972). For a thoughtful analysis of the above proposals, see Blake, *Legislative Proposals for Industrial Deconcentration*, in H. GOLDSCHMID, H. MANN, & J. WESTON, *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* 340 (1974).

Appendix A *

Corporate Management and Shareholder Profit Maximization Investment Decision Models

The formal models described below assume a primary management and shareholder motivation to maximize profits and net revenues as contrasted with maximizing gross revenues, rate of growth, earnings per share, or some other measure. Since corporate management units are now considering all forms of diversification in their investment decisions, the models incorporate the possibilities of divestiture and unification, partial or complete.

Nomenclature

- A = corporation considering diversification alternatives
- S = wholly owned (100% stock) subsidiary corporation of A
- T = potential acquisition target corporation
- a = constant varying between 0 and 1
- b = constant varying between 0 and 1
- k = constant varying between 0 and 1

Let the state of nature before a diversification decision be given by:

$$aA + bS - kT \tag{1}$$

where $a = b = k = 1$. Thus $A + S$ represents the current net worth of the total assets of corporation A and its subsidiary S.

$$aA + bS + kT \tag{2}$$

*The formulations herein commencing with equations (4) and following are the author's modifications of formulations developed by Arnold Reisman which appear in his excellent work, A. REISMAN, *MANAGERIAL ENGINEERING AND ECONOMICS* (1971). The numbers in the second parentheses of the equations listed correspond to the equation numbers appearing in the Reisman text. Unless otherwise noted, the Reisman equations are not modified. The author wishes to thank Walter Gellhorn and the late Wolfgang Friedman of Columbia University Law School; Donald Warden, President, Cygnus Corporation; Sanford Sarasohn of St. Louis University; Robert Hellawell, William Young, George Cooper, Richard Stone and Kellis Parker of Columbia University; Walter Leonard of Harvard University; Alan Ruben, Stephen Werber, David Goshien, Hyman Cohen, Carrol Sierk and William Tabac of Cleveland State University; David Funk of Indiana University; Laurie Leader of Cleveland State University; Charles Donegan of Howard University; Adrian Krage, Lawrence Stone, and John McNulty of University of California Berkeley for their help although none are responsible for any errors or policy judgments contained in the article or the appendices.

The author expresses deepest possible appreciation to Dr. Arnold Reisman of the Department of Operations Research, Case Western Reserve University, for taking time to evaluate and discuss developments of the models described and the general application of a systems analysis approach to legislative and judicial decision-making. The author, however, is solely responsible for any possible errors in the formalistic models presented.

where $0 < k \leq 1$

$$\begin{aligned} a &= 1 \\ b &= 1 \end{aligned}$$

describes the Corporation, its division or subsidiary, and a partial to total acquisition of corporation T.

Equation (2) describes a partial to total acquisition of T combined with a partial to total divestiture of S where

$$\begin{aligned} 0 &< k \leq 1 \\ 0 &\leq b < 1 \\ a &= 1 \end{aligned}$$

A partial to total divestiture of S with no acquisition is described by Equation (2) where

$$\begin{aligned} k &= 0 \\ a &= 1 \\ 0 &\leq b < 1 \end{aligned}$$

A partial to complete liquidation of A + S exists where

$$\begin{aligned} k &= 0 \\ 0 &\leq a < 1 \\ 0 &\leq b < 1 \end{aligned}$$

$$- (aA + bS + kT) \tag{3}$$

describes involuntary liquidation or insolvency where

$$\begin{aligned} k &= 0 \\ 0 &< a \leq 1 \\ 0 &\leq b < 1 \end{aligned}$$

Under the above formulations, the constants a, b, and k represent weighted averages of the range of asset and revenue capabilities of corporations A, T, and A's wholly owned subsidiary corporation S.

For purposes of simplification, let us consider only four possible types of diversification:

(a) A + S = management decides there is no advantage to either unification or divestiture;

(b) A - S = management determines that complete divestiture of S is most advantageous;

(c) A - S + T = management determines that total acquisition of T along with complete divestiture of S is most advantageous;

(d) A + S + T = management decides that total acquisition of T is most advantageous.

Now let P represent the present enterprise worth of the ownership and operation of a company after diversification pursuant to any of the above decisions such that:

$$-P = -B + L - E + R^a \quad (4) \quad (3.3-5.1R)$$

where B = aggregate purchase price of enterprise assets

L = projected liquidation value of enterprise

E = expenses

R = revenues

For purposes of simplification our general equation assumes either complete acquisition of a target company T or complete liquidation of subsidiary company or division S such that only one purchase or sale is involved in computing the resulting present worth of the enterprise existing after the transaction. In such case, the maximum profit over a given period of time T , measured in years, can be represented by the following equation:

$$-P = -B + L(T) e^{-rT} - \int_0^T E(t) e^{-rt} dt + \int_0^T R(t) e^{-rt} dt \quad (5) \quad (7.4-0.1R)$$

where B = aggregate purchase price of enterprise assets

$R(t)$ = projected revenue to time relation

$E(t)$ = projected expense to time relation

$L(T)$ = projected liquidation market value to time relation

r = enterprise cost of capital or discount rate

Equation (5) may be modified by taking into account the corporate tax rate, T^c ; corporate tax rate on corporate capital gains, T^{cg} ; the nontaxable refund of a capital loss carry-back from sale of stock in an unprofitable subsidiary or division in the amount of $T^{cg}(B^c - P^c)$,^b namely the product of the capital gains tax rate and the difference between the purchase and sale prices of the loss stock; post-transaction year capital gains; nondeductible interest payments on preferred stock, I^p , at interest rate p .

Now, consider the following variable definitions:

$-P$ = net total enterprise worth discounted at rate, r , over period T .

$-B$ = aggregate purchase price of enterprise assets.

a. The sign convention used is appropriate for profit maximization studies while the reverse, equally correct, would be better for cost minimization studies. See A. REISMAN, *MANAGERIAL AND ENGINEERING ECONOMICS* (1971).

b. In 1969, I.R.C. section 1212 was amended to permit corporations experiencing net capital losses to carry back those losses against the prior three years' gains with the government providing a refund within 90 days.

-C = costs of transaction (attorneys, promoters, registration fees).

$L(T)$ = expected market liquidation value of enterprise at end of period T.

T^{CG} = tax rate on corporate capital gains.

B^c = purchase price of capital assets.

P^c = sale price of capital assets.

p = rate of dividends payable on preferred shares.

T^c = corporate tax rate on gross income.

R = gross enterprise revenues.

E = total enterprise expenses deductible from gross income.

I_0 = aggregate enterprise assets represented by common equity at the time of the transaction.

I^R = retained earnings.

I^D = outstanding debt on which interest paid is deductible from gross income.

I^P = outstanding preferred shares with no deduction for dividends paid.

I^{NE} = new common equity issued within a period t.

I^{ND} = new debt securities issued within a period t.

I^{NP} = new preferred shares issued within a period t.

\bar{r}_a = average rate of return on enterprise investments.^c

E_0 = enterprise operating expenses deductible from gross income.

\bar{d} = rate of interest payable on enterprise debt deductible from gross income, given as a weighted average.

S = salvage value of enterprise assets estimated at end of period t.

N = estimated number of years for useful life of depreciable assets at end of period t.

$\frac{B-S}{N}$ = average straight line annual depreciation on enterprise assets.^d

c. As defined $\bar{r}_a > r$, the enterprise rate of discount or cost of capital. \bar{r}_a is to be distinguished from shareholder rate of return on equity, corporate rate of return on assets, and corporate rate of return on revenues. For informative discussions on various methods and problems associated with determinations of capitalization rates, see 25 NAT'L TAX J. 193-330 (1972).

d. For simplicity, the model assumes the straight line method of depreciation,

L_0 = net operating loss carryover from prior tax years of either the acquiring or acquired company.

T = finite period of time, in years, over which algebraic sum of enterprise assets is discounted.

t = incremental period of time, in years, within total period of time T .

d_n = rate of interest payable on new debt issued.

A modification of equation (5) can thus be represented by:

$$\begin{aligned}
 -P = & -B - C + L(T) e^{-rT} + (T^{cg})(B^c - P^c) e^{-r(T-1)} \\
 & + \int_{t+1}^T (1 - T^{cg})(P^c - B^c) e^{-rt} dt - \int_0^T (I^P_p) e^{-rt} dt \\
 & + \int_0^T (1 - T^c)(R(t) - E(t)) e^{-rt} dt \quad (6)^e
 \end{aligned}$$

where: $R(t)$ represents gross revenues as a function of time and $E(t)$ represents deductible expenses as a function of time.

$$R = I_0 \bar{r}_a + I^R \bar{r}_a + I^D \bar{r}_a + I^P \bar{r}_a + (I^{NE} + I^{ND} + I^{NP}) \bar{r}_a \quad (7)$$

and

$$E = E_0 + I^D \bar{d} + I^{ND} d_n + \frac{B - S}{N} + L_0 \quad (8)$$

Explanation of Terms in Equation (6)

The first term in equation (6) represents the aggregate purchase price of enterprise assets. The second term represents costs of the transaction, which may be significant if securities are issued in connection with the diversification. The third term is the estimated market value of total enterprise assets on liquidation at the end of

although many, if not most large enterprises use some method of accelerated depreciation permitted by I.R.C. § 167 and the accompanying Treasury regulations.

e. It should be noted that the capital loss carryback refund would be immediately reinvested at the enterprise's rate of return on investment, $r_a > r$, and this annual amount would be taxable gross income; the model assumes this result by positing that the refund amount increases the retained earnings, I^R , in the year of the transaction at time $t = 0$.

Equation (6) does not contain an explicit expression for the payment by the purchasing corporation of any capital gains taxes to be paid by shareholders of the selling company, but such agreement may be accommodated in the model by appropriate adjustment of the aggregate assets purchase price, $-B$.

If the transaction involved the sale of loss stock in a poorly performing division or subsidiary, there would be no capital gains in the transaction year and thus the fifth term of equation (6), representing net, after tax capital gains income, is compounded over the period T commencing with the first year after the transaction.

In a similar fashion, the net operating loss carryover, L_0 , in equation (8) exists in the year prior to the transaction but under I.R.C. § 381 may offset taxable income in later years provided the requirements of I.R.C. § 382 are met.

period T , discounted at the company's capitalization rate, r . The fourth term is the amount of the corporate capital loss carryover refund received at the beginning of the year after the transaction, $t+1$, discounted over the remaining period of time $T - 1$. The fifth term accommodates any anticipated receipt of annual capital gains income, net of corporate capital gains taxes commencing with the year after the transaction; if in the year of the transaction there is no net capital loss, then the integral of the fifth term would range from zero to T . The sixth term represents annual nondeductible dividend payments on preferred shares; the term could be appropriately adjusted to include payments on previously and newly issued preferred shares. The seventh and last term represents annual revenues less deductible expenses and corporate taxes.

Assumptions and Limitations of Model Equation (6)

The factor of possible convertibility of debt securities is not taken into account in the model although such factor would affect the underlying per share equity value of total enterprise assets.

Inflation of the value of assets and increases or decreases in growth rates of rates of return could be accommodated in the model described in equation (6) by appropriate adjustment to \bar{r}_a and r . Accordingly, the formulation of equation (6) is useful for its approximation of the enterprise net worth at a given period of time assuming conditions remain relatively stable over the discounting period. This approximation would enable corporate management to determine the relative enterprise worth, taking into account significant tax factors, for the stated range of forms of diversification.

The model of equation (6) would also allow corporate management and government tax policy-makers alike, to determine the net effect of federal taxes on the form of diversification by solving the equation for the algebraic sum of tax variables and fixing the value of all other variables computing the results for each type of diversification.

Method for Measuring Stock Received by Selling Shareholder

The general form of equation (4) may also be modified to measure the value of stock received in the acquiring company by a shareholder of the acquired company. Consider:

$$-P = - [B_T + (P_T - B_T)] + P_N + D \quad (9)$$

where:

$-P$ = net value of a share of stock received discounted over a finite period.

P_T = purchase price of shares in acquiring company.

B_T = average purchase price of shares in acquired company.

P_N = expected future sale price of stock received.

D = annual expected dividends on stock received.

Now, consider the following variable descriptions:

B_T = average purchase price of stock held by shareholder in acquired company.

P_T = price for sale of shares in acquired company received by selling shareholder.

T^g = individual tax rate on capital gains.

R = gross revenues of combined enterprise as defined in equation (7).

T^c = corporate tax rate on gross income.

E = expenses deductible from gross income of combined enterprise as defined in equation (8).

I^R = retained earnings of combined enterprise.

I^P = value of outstanding preferred shares of combined enterprise.

p = rate of dividend payments on preferred shares.

T^P = individual tax rate on preferred dividends.

P_N = expected future sale price of total shares in acquiring company received by selling shareholder.

W_T = net enterprise worth of acquired company as represented by common equity of acquired company.

N_T = number of outstanding shares of common equity of acquired company.

Equation (9) may be modified, considering significant tax variables, resulting in the following formulation:

$$\begin{aligned}
 -P &= -[B_T + (P_T - B_T)(1 + T^g)] + P_N e^{-rT} \\
 &+ \int_0^T [(1 - T^c)(R(t) - E(t)) - (I^R + I^P p (1 - T^P))] e^{-rt} dt \\
 &+ (P_N - P_T)(1 - T^g) e^{-rt} \tag{10}
 \end{aligned}$$

where:

$$P_T = \frac{W_T}{N_T}, \text{ and} \tag{11} \quad (11.1-2.10R)$$

$$W_T = \frac{I_{0T} - I_T^D - I_T^P + I_T^R}{N_T} \tag{12} \quad (14.2-2.6R)$$

I_{0T} = enterprise assets of acquired company due to common equity.

I_T^D = outstanding debt of acquired company.

I_T^P = outstanding preferred shares of acquired company.

I_T^R = retained earnings of acquired company.

In equation (10), the first term represents the purchase price of acquiring company shares paid by the selling shareholder of the acquired company including payment of capital gains taxes. If stock in the acquiring company is received in a nonrecognition exchange, T^G would be zero. It should also be noted that P_T in the first term might include an additional amount to compensate the selling shareholder for capital gains tax liability. The second term represents the expected future sale price of acquiring company shares when investment is liquidated. The third term represents the annual dividends received by the shareholder of the selling company on newly acquired shares in the acquiring company. The fourth and last term represents the expected future gain on sale of the shares in the acquiring company after payment of capital gains taxes. Equation (10) could be appropriately modified to accommodate the receipt by the selling shareholder of debt securities in exchange for stock in the acquired company. Such modification would entail adding a positive term for the receipt of annual interest on such debt securities, integrated over the length of the time horizon, T . P_N would then represent the expected value of such securities at the end of the period.

Finally, variables in the third term of equation (10) assume ratable shareholder amounts calculated on a per share portion of total outstanding common equity of the combined enterprise.

Appendix B

*Determination of Relative Net Gain From Corporate Issuance of Equal Amounts of Stock or Debt Securities**Variable Description*

r_e = corporate investment rate of return

r_i = interest rate payable on debt securities

r_d = dividend rate payable on stock issued

T^c = corporate tax rate on gross income

I^{ND} = amount of new debt issued

I^{NE} = amount of new equity stock issued

G_{ND} = net gain on earnings from proceeds of debt issued after corporate tax

G_{NE} = net gain on earnings from proceeds of stock issued after corporate tax

Now, let $I^{ND} = I^{NE} = 1$. The net proceeds from debt earnings,

$$G_{ND} = r_e I^{ND} - r_e I^{ND} T^c - r_i I^{ND} + r_i I^{ND} T^c \quad (1)$$

The first term to the right of the equals sign is the earnings from the issuance at the corporate internal rate of investment return, less corporate tax on such earnings, less interest payments, plus the tax savings on the deduction of interest payments. Since I^{ND} and I^{NE} are defined as equal to one, equation (1) can be reduced to

$$G_{ND} = r_e(1 - T^c) - r_i(1 - T^c) \quad (2)$$

Similarly, the net proceeds from issuance of an equal amount of stock,

$$G_{NE} = r_e I^{NE} - r_e I^{NE} T^c - r_d I^{NE} \quad (3)$$

The first term to the right of the equals sign is the earnings for the stock issuance proceeds at the corporate internal investment rate of return, less corporate tax on such earnings, less the amount of dividends paid. By simplifying equation (3), it can be reduced to

$$G_{NE} = r_e(1 - T^c) - r_d \quad (4)$$

Subtracting equation (4) from equation (2) we obtain,

$$G_{NE} - G_{ND} = r_i(1 - T^c) - r_d \quad (5)$$

For $G_{NE} - G_{ND}$ to be greater than zero, it is necessary that

$r_i(1-T^c)$ be greater than r_d . Thus, where T^c is 50% (.50),

$$\frac{r_i}{2} \text{ must be greater than } r_d, \text{ or,} \quad (6)$$

$$r_d \text{ must be less than } \frac{r_i}{2} \quad (7)$$

Thus, assuming issuance of equal amounts of either stock or debt, in order for corporate net gain from equity to exceed that from debt, the dividend rate on the equity must be less than one-half the rate of interest payable on debt, given a corporate tax rate of approximately 50%.