Taxing the Publicly Traded Stock In a Corporate Acquisition

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The proposal would treat publicly traded stock received by target shareholders in an acquisitive reorganization as boot. Because target shareholders drop by more than 20 percent, the gain would be taxable as capital gain. Publicly traded partnership interests would be treated the same. There would be no gain or loss at the corporate level, however, even if the target corporations acted as a conduit to shareholders. Shareholders would not be taxed under this proposal if their corporation issues new stock, even if control changes, and if existing shares become publicly marketable.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue without raising tax rates, defend the tax base, and improve the rationality and efficiency of the tax system. Given the calls for economic stimulus, some proposals may stay on the shelf for a while. A longer description of the project is found at ''The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Under current law, if a corporate acquisition qualifies as a reorganization, the target shareholders do not recognize built-in gain on the stock they surrender when they receive publicly traded stock. The proposal would treat publicly traded stock as sufficiently cashlike to be taxed as boot in a reorganization. Publicly traded stock can be readily converted to cash and market quotes foreclose any serious valuation disputes. A 15 percent capital gains tax would be imposed on realized shareholder gain. However, shareholder gain or loss would have no impact on the corporate level. Publicly traded partnership interests would be treated consistently. Receipt of restricted-sale stock would be taxed as if the stock had no sale restrictions. Restrictions on votes or the absence of votes would be ignored.

Acquisitions can also be accomplished by the target corporation issuing sufficient new stock to a new controlling corporate shareholder. Under those circumstances, the target shareholders hold the same shares after the transaction as before, but the nature of the interest has radically changed. For this proposal, it is generally concluded that a minority interest in a subsidiary not traded on an established market and controlled by the acquiring corporation is a rotten enough position that nothing need be done to force the recognition of gain to the target shareholders. This proposal would also not tax shareholders when their shares become salable on an established market.

A. Current Law

Under current law, the shareholders of a target corporation can avoid the recognition of built-in gain on their stock when the target is acquired. The shareholders will recognize neither gain nor loss when they surrender their stock in exchange for stock of the acquiring corporation in a reorganization qualifying under section 368.[1] The core rationale for nonrecognition is ''the underlying assumption . . . that the new property is substantially a continuation of the old investment still unliquidated.''[2] Acquisitions qualifying as reorganizations are said to be ''only a readjustment of continuing interest in property under modified corporate form.''[3] Like-kind exchanges are similarly treated as nonrecognition events, originally by reason of the same subsection of the code, under the rationale that ''the taxpayer's money is tied up in the same kind of property as that in which was originally invested.''[4]

By contrast, if the target shareholders receive boot (cash or other property that is not the permissible stock or securities of the acquiring corporation), the gain in the target shares is taxed to the extent of the boot.[5] Boot is allocated first to the gain element of the surrendered stock. Only after all the gain is taxed will the shareholder get a recovery of his basis. Taxation of the boot to the extent the taxpayer liquidates his investment is a necessary part of the rationale for nonrecognition, which is that the taxpayer has not liquidated his investment. Shares of the acquiring corporation are not considered

[1]Section 354.

[2]Reg. section 1.1002-1(c) (1960).

[3]Reg. section 1.368-1(b) (2007).

[4]House Ways and Means Committee, H. Rep. No. 73-704 (1934), *reprinted in* 1939-1 (Part 2) C.B. 554, 564.

[5]Section 356. The parallel provision, taxing boot in a like-kind exchange, is section 1031(b).

boot under current law, however, even when they are traded on an established public market and are so easily sold that they are cashlike.

In theory, the nonrecognition in a corporate acquisition is not a forgiveness of stock, but a deferral of tax until the acquiring corporation's property is sold. Section 358 requires basis calculations for the acquiring corporation stock so that gain built into the target stock surrendered but not taxed in the transaction will remain in the replacement stock. Basis in the acquiring corporation shares is the same as basis in the original target shares, increased by the gain recognized by reason of boot in the acquisition and decreased by the total basis allocated away from the acquirer stock to cash and other boot received.[6]

In reality, however, the realized gain that is not taxed in the reorganization is usually never taxed. Economists estimate that only between 20 percent[7] and 46 percent[8] of untaxed gain will ever be taxed. Most of the unrecognized gain disappears because section 1014 provides for a step-up in basis for property received by reason of death of the prior owner. Taxpayers avoid recognition of net gain that is built into the replacement property until death, sometimes with further nonrecognition transactions and sometimes by waiting to report their gains until they have offsetting losses. Moreover, basis rules are not well enforced, and the section 358 rules are hard for laymen to understand.[9] Even for tax that is paid eventually, the deferral reduces its net present value. Given the deferral and forgiveness of tax, the expected value of the tax on the gain realized in a corporate acquisition but not taxed is between 2 percent and 4 percent.[10]

[6]Section 358(a).

[7]Laurence Kotlikoff, ''Intergenerational Transfers and Savings,'' 2 *J. of Econ. Persp*. 41, 43 (Spring 1988); Laurence Kotlikoff and Lawrence Summers, ''The Role of Intergenerational Transfers in Aggregate Capital Accumulations,'' 89 *J. of Pol. Econ*. 706 (1981) (estimating that once savings arise, 80 percent is held until death). If 80 percent of all wealth is held until death, we should expect wealth at death to be especially rich in unrealized gain, given the incentives to hold high-gain property and rely on loss or low-gain property to support the standard of living. Kotlikoff's measures would thus support a finding that less than 20 percent of unrealized gain is taxed.

[8]Jane G. Gravelle, ''Limit to Capital Gains Feedback Effects,'' at 4 (Congressional Research Service 1991) (taking out timber, housing, and nonprofit results and finding that 46 percent of accrued gains are realized); *but see* prior work, Jane G. Gravelle and Lawrence B. Lindsey, ''Capital Gains,'' *Tax Notes*, Jan. 25, 1988, p. 397 (76 percent of capital gains are held until death, so only 24 percent are eventually recognized).

[9]Joseph Dodge and Jay Soled, ''Debunking the Basis Myth Under the Income Tax,'' 81 *Ind. L. J*. 539 (2006). Dodge and Soled argue that penalty incentives are not strong enough to make it rational for taxpayers to comply with basis rules and that antigovernment anger would suppress compliance even if effective enforcement made it rational to comply.

[10]This calculation assumes a capital gains rate of 15 percent, a discount rate of 5 percent, and 10 years of deferral. The expected tax is calculated as probability of tax times discounted present value: 20 percent*{15 percent/1.05^{10}} = 1.8 percent, and 46 percent*{15 percent/1.05^{10}} = 4.2 percent.

The three basic acquisitive reorganizations — A reorganizations, B reorganizations, and C reorganizations — draw their names from the subparagraphs of section 368(a)(1) that describe them.[11] An A reorganization is a merger. In a merger, the assets and liabilities of the target corporation shift to the surviving corporation by operation of law, and the target corporation disappears. The shareholders of the target corporation surrender their shares in exchange for shares of the surviving acquiring corporation. A B reorganization is an acquisition of target stock in an exchange directly between the acquiring corporation and the target shareholders. At the end of the exchange, the target corporation is a subsidiary of the acquiring corporation, with no change to the target assets. To qualify as a B reorganization, the acquiring corporation must use only its own voting stock and must own at least 80 percent of the target stock at the end of the transaction. A C reorganization is an acquisition of target assets from the target corporation. The target corporation then liquidates, disgorging to its shareholders the acquiring corporation stock it has received in the exchange.[12] At the end of the asset exchange and liquidation, the acquiring corporation owns substantially all the assets of the target, and former target shareholders own shares of the acquiring corporation.

Tax-free acquisitions can be effected using not only the reorganization definitions of section 368, but also through transfers to a controlled (80 percent owned) corporation governed by section 351. Section 351 is also used to form a new enterprise through contributions from one or many subscribers in exchange for stock of the new corporation. In an acquisitive section 351 transaction, the target shareholders contribute their shares to the new corporation, and that transfer is coordinated with the acquiring corporation contributing enough stock or other property to become the controlling shareholder of the new corporation. The target shareholders end up owning a minority interest in the new corporation, which is a subsidiary controlled by the acquirer. The use of section 351 to accomplish the acquisition is sometimes called a National Starch transaction, named for a transaction that achieved a favorable IRS ruling.[13] Sections 351 and 368 were originally enacted in 1921 as sequential

[11]Section 368(a)(1)(A), (B), and (C).

[12]Section 368(a)(2)(G). The target may remain in existence, with Treasury's permission, provided that it is a lifeless shell holding acquiring corporation stock that has been liquidated in substance. *See* section 368(a)(2)(G)(ii); Rev. Proc. 89-50, 1989-2 C.B. 631.

[13]LTR 78839060 (June 23, 1978). Rev. Rul. 84-71, 1984-1 C.B. 106, confirms the result in public. In Rev. Rul. 80-284, 1980-2 C.B. 117, and Rev. Rul. 80-285, 1980-2 C.B. 119 (revoked by Rev. Rul. 84-71), the Service would have applied continuity of interest principles to section 351 if the formation of the new corporation was part of a larger transaction that was really a corporate acquisition. The rich planning use of the National Starch ruling is described in Martin Ginsburg and Jack Levin, 1 *Mergers, Acquisitions and Leveraged Buyouts*, ch. 9 (1998 ed.).

paragraphs of the same subsection,[14] and both are considered to be a continuation of the taxpayer's same investment in modified corporate form.[15]

The different reorganization techniques allow different levels of boot. For a B reorganization (stock acquisition), the acquiring corporation can use only its own voting stock and no boot. For a C reorganization (asset acquisition), the acquiring corporation can use some boot, as long as its voting stock is used to acquire substantially all the assets of the target.[16] The merger or A reorganization is the most liberal of the section 368 reorganizations regarding the kind of consideration that can be given in the acquisition. In a merger, nonvoting and preferred stock may be used as consideration given to target shareholders for their shares, and boot (cash or other property) may be used to buy out dissenting target shareholders who do not want to come into the amalgamation. Judicial-doctrine continuity of interest must be maintained in an A reorganization merger, but the IRS has ruled that the doctrinal continuity is satisfied if target shareholders holding at least half the value of the target stock end up with stock of the acquirer.[17]

The common-law continuity of interest rules do not apply to section 351 acquisitions, however. In one transaction, 85.5 percent of the target shareholders were bought out with cash, and the preferred stock given to the remaining target shareholders still qualified for nonrecognition.[18] The different levels of boot — and indeed all the differences in the technical requirements for A, B, C, and section 351 acquisitions — have accreted in small increments over the years, and they have never been engineered into a coordinated set of rationales or rules.

Acquisitive reorganizations provide nonrecognition even when the target shareholders acquire only a small fraction of the ownership of the amalgamated entity. Thus, in *Minnesota Tea Company v. Commissioner*, the target corporation achieved only 7.5 percent of the shares of the amalgamation after an asset acquisition. The Board of Tax Appeals held that the acquisition did not constitute the required "continuing interest in the same property through a mere change in forms of ownership," but was "rather an almost complete change in the essential assets owned."[19] The court of appeals reversed, and the Supreme Court affirmed the reversal on grounds that the acquisition complied literally with the statute. Continuity represented by a low percentage in the acquiring company was "not inhibited by the statute."[20] So reorganization character applies even when a whale swallows a minnow and the minnow shareholders end up with very different interests from what they previously held.

Since 1994, publicly traded stock distributed by a partnership has been treated as money. Historically, a distribution of property from a partnership to a partner, including distributions of marketable stock, was a nonrecognition event to both the partnership and the partner. Under section 731, the partner had no gain from a distribution, except when cash distributed exceeded the partner's basis.[21] In 1994, however, Congress amended section 731 to provide that marketable securities distributed by a partnership were generally to be treated as cash. Cash distributions from a partnership are first a recovery of a partner's basis and then taxable gain.

B. Reasons for Change

1. Cash equivalency. Publicly traded stock is a lot like money and should be treated as money. Publicly traded stock is easy to value and easy to turn into cash for other uses. Unrealized appreciation is not included in taxable income, although it represents a true improvement to the taxpayer's economic position because of concerns that valuation of the property might be difficult and concerns that the taxpayer would not have the cash to pay the tax.[22] Publicly traded stock avoids both concerns. The market value is readily established any place in the world by the continually updated market price quotes, and shares traded on an established market are easily converted to cash by a sale during market hours.

As noted, in 1994 Congress amended the traditional nonrecognition for distributions of publicly traded stock by a partnership to provide that distributions of publicly traded stock be treated like distributions of cash. The explanation given by the House Ways and Means Committee for the 1994 change governs receipts of marketable securities in other nonrecognition contexts equally well:

> If the taxpayer were to exchange an interest in an appreciated asset for cash, he generally would recognize gain on the appreciated asset; yet if the taxpayer receives a partnership distribution of marketable securities, which are nearly as easily valued and as liquid as cash, he can avoid gain recognition.
>
> This distinction in tax treatment between cash and marketable securities elevates form over substance, causes taxpayers to choose the form of transactions for tax reasons rather than economic reasons, and may not promote accurate income measurement. Rather, the present-law rule merely permits taxpayers to defer or avoid tax.[23]

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[14]Revenue Act of 1921, Pub. L. No. 67-98, section 202(c)(2) (reorganizations) and (c)(3) (transfers to controlled corporation).

[15]*See supra* notes 2-4 and accompanying text.

[16]Rev. Proc. 77-37, 1977-2 C.B. 586, provides that a ruling will be available if 70 percent of the gross assets of the target and 90 percent of the assets net of liabilities of the corporation are acquired for stock.

[17]Rev. Rul. 66-224, 1966-2 C.B. 114.

[18]*National Starch v. Commissioner*, 93 T.C. 67 (1989), *aff'd*, 918 F.2d 426 (3d Cir. 1990), *aff'd sub nom. INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

[19]*Minnesota Tea Co. v. Commissioner*, 28 BTA 591 (1933), *rev'd*, 76 F.2d 797 (8th Cir. 1935), *aff'd*, 296 U.S. 378 (1935).

[20]*Minnesota Tea*, 296 U.S. 378 at 385-386.

[21]Section 731(a).

[22]*See, e.g.*, Marvin Chirelstein, *Federal Income Taxation: A Law Student's Guide to Leading Concepts and Cases*, 74 (11th ed. 2009).

[23]H.R. Rep. No. 103-826(I) at 187-188 (1994). Phillip Gall and David R. Franklin, "Partnership Distributions of Marketable Securities," *Tax Notes*, Nov. 12, 2007, p. 687, *Doc 2007-23551*, or *2007 TNT 220-38*, suggest that given the taxation of market securities in a distribution by the partnership, "the corporate

(Footnote continued on next page.)

Cash is useless paper, except that it can be converted into goods or services, including property like readily marketable stock. When cash and marketable securities can be converted to each other so easily, there is no viable distinction between them.

A tax system that taxes cash but not substitutes for cash is too easy to avoid. Taxpayers avoid tax by avoiding cash, and the tax avoidance is a lose-lose situation. The Treasury makes no revenue from the avoided tax, and it must collect its revenue from some inferior source. Taxpayers do themselves damage avoiding the cash, sometimes up to a level just shy of the value of the tax avoided.

After a reorganization exchange, target shareholders maintain an investment in stock of the acquirer. The reinvestment of stock sale proceeds into a like-kind stock, however, is generally a justification for applying capital gains rates to the sale under current law, but is not a justification for no tax on the sale or exchange. Reinvestment of the proceeds of sale of the investment is the primary reason why capital gains rates are available for sale of the investment. In 1921 the Supreme Court in *Merchants' Loan & Trust Co. v. Smietanka* allowed tax to be imposed on a trust's sale of corpus property.[24] Gains from the sale in the corpus stock had to be reinvested in corpus and were not distributable or accessible to the income beneficiaries. Within months of the decision, Congress reacted by according gains from the sale or exchange of capital assets a maximum tax rate of 12.5 percent — at a time when maximum rates on ordinary income were 54 percent.[25] Congress was also imitating existing British law, which exempted capital gains on the assumption that they had to be reinvested.[26] In 1923 Congress took corporate stock and partnership interests out of the like-kind exchange nonrecognition provisions, saying that taxpayers were abusing the nonrecognition rules by avoiding recognition of gains but recognizing losses by sale.[27] Since 1923, an exchange of stock for other stock is a taxable exchange even though the proceeds of the sale remain invested in stock, except when the exchange qualifies as a reorganization or as a transfer to a controlled corporation. The like-kind exchange with stock is eligible for capital gains rates, but it is taxed.

The stated rationale for nonrecognition in reorganizations is that an acquisition is ''only a readjustment of continuing interest in property under modified corporate form.''[28] After a corporate acquisition for publicly traded stock, continuing interest is true only in the most esoteric sense. Look, for example, at a taxpayer who owns all the stock of a small business, which he runs without compromise but is illiquid and unmarketable. The taxpayer exchanges all his stock for publicly traded stock constituting less than 0.01 percent of the stock of a public company. As a minority shareholder of the publicly traded company, the shareholder may not interfere in the business judgments made by the public company's board of directors.[29] The shareholder has a negligible chance of making a difference in the outcome of the vote for members of the board.[30] Votes on the stock matter only in extraordinarily rare circumstances. If a minority shareholder does not like the corporation's business decisions, his de facto remedy is to sell the stock. The dependency of his economic returns on the assets of his former company is so diluted as to be properly ignored. The post-transaction value for the taxpayer is that the stock he has received is an investment that can easily be converted to cash. In substance, the taxpayer does not own the same property in altered form; he has sold his small business for a cash-equivalent asset and is no longer its owner in any meaningful sense. In the reorganization exchange, the taxpayer does maintain an investment in stock, but that investment has not been sufficient for nonrecognition since the reforms of 1923.

Over the years the courts and Congress, working in concert, have developed a multifaceted continuity of interest doctrine that must be satisfied for a transaction to qualify for nonrecognition. The function of the continuity of interest doctrine is to distinguish reorganizations (as used in the statute) from ''mere sales.''[31] In *Pinellas Ice & Cold Storage Co. v. Commissioner*, for instance, the Supreme Court held that an asset acquisition achieved with short-term notes was not a reorganization because ''these notes — mere evidence of obligation to pay the purchase price — were not securities within the intendment of the act and were properly regarded as the equivalent of cash.''[32] Congress has praised the courts for preventing nonrecognition for disguised sales, and it has adopted restrictions to conform to the idea.[33] Under current law, the continuity of interest doctrine does allow an exchange of target shares or assets for a minority interest in publicly traded stock to qualify as a reorganization,[34] but on the merits these transactions are mere sales for cash-equivalent sale proceeds.

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reorganization provisions should be amended to prevent taxpayers from exchanging illiquid stock or corporate assets for publicly traded stock in a tax-free manner.'' However, Gall and Franklin say the suggestion will ''likely be viewed as heretical.''

[24] *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921).

[25] Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227, 237, sections 210 (4 percent normal tax), 211(a)(2) (50 percent surtax), and 206(b) (12.5 percent tax on capital gain).

[26] *See* Calvin H. Johnson, ''Taxing the Consumption of Capital Gain,'' 28 *Va. Tax Rev*. 477, 488-496 (2009).

[27] Act of March 4, 1923, P.L. No. 67-545, section 1; Ways and Means Committee, H. Rept. No. 67-1432, *reprinted in* 1939-1 C.B. 846 (testimony of Treasury Secretary Andrew Mellon).

[28] Reg. section 1.368-1(b) (2007).

[29] The classic case is *Dodge v. Ford Motor Co.*, 20 Mich. 459 (1919) (dismissing suit to compel dividends). Note also the title of Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994).

[30] Luigi Zingales, ''What Determines the Value of Corporate Votes?'' 110 *Q. J. of Econ*. 1047, 1049 (1995) (in normal times when there is no prospect of a battle for corporate control, the value of votes is negligible and can be ignored).

[31] *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932) (asset acquisition for cash and short-term liabilities).

[32] *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 468-469 (1933).

[33] H.R. Rep. No. 73-704, *supra* note 4, at 13-14.

[34] *Minnesota Tea*, 296 U.S. 378 at 385-386.

Mergers With Stock and Boot[a]				
Year	Stock Only	Cash Only	Mixed	Total Cash and Mixed
2000	43 [30%]	43 [30%]	57 [40%]	100 [70%]
1977-2000	1,218 [34%]	1,542 [43%]	799 [22%]	2,341 [65%]

[a]Matthew Rhodes-Kropfa et al., ''Valuation Waves and Merger Activity: The Empirical Evidence,'' 77 *Journal of Financial Economics 561, 569* (2005) (citing Securites Data Corporation merger database as source). The data is nontax data. Gain is taxed first in a mixed acquisition, but the boot might not be enough to tax all the gain.

2. Modest impact. Gain is already recognized in 65 percent to 70 percent of corporate acquisitions, even though tax-free acquisitions are available under current law for acquisitions using entirely acquirer stock. (See table above.)

A recent review of the literature found that acquirers' stock performed better after a cash acquisition than after a merger acquisition with stock,[35] implying that acquirers would do better to contract the proportion of stock mergers that they undertake even under current law.

With tax-free acquisitions no longer available under the proposal, some proportion of the 30 percent to 34 percent of tax-free acquisitions under current law would not happen. Many acquisitions within the 30 percent to 34 percent range would go forward, however, even with the (modest) proposed increase in tax. The proposal would raise tax on the stock-only acquisitions to 15 percent, the capital gains rate. Current law leaves the target shareholders with a possibility of future tax on the gain built into the target shares, and that possibility is evaluated at an expected burden of 2 percent to 4 percent.[36] The proposal would thus increase tax on 30 percent to 34 percent of acquisitions that use stock, by between 11 percent and 13 percent of the gain. The increased toll charge is modest, but it would suppress some corporate acquisitions within the 30 percent to 34 percent that rely on tax-free reorganizations.

Some of the suppression of corporate acquisitions will have beneficial antitrust effects. Corporations with an enlarged market share can raise prices more above their marginal costs and collect higher rents from customers. Suppression of the 30 percent to 34 percent of acquisitions that now use nonrecognition will stop some increases in market share. Some of the suppression of corporate acquisitions will have a negative effect: A corporate acquisition can bring in new management that uses target assets more efficiently. The plausible threat of an involuntary corporate takeover can force management to be more efficient in its use of corporate assets. A merger might create a synergism when the two sets of assets are pooled. Suppression of the 30 percent to 34 percent of acquisitions that use nonrecognition will reduce the threat of takeover. Some of the mergers would allow economies of scale and reduction of redundant costs.

[35]Jerayr Haleblian, et al., ''Taking Stock of What We Know About Mergers and Acquisitions,'' 17-18 *Journal of Management* (forthcoming 2009).

[36]*See supra* note 13 and accompanying text.

However, the baseline for evaluating the impact of the proposal is the premise that publicly traded stock is so close to cash that it is unjust to tax cash if stock is not taxed. From the reasonable baseline that publicly traded stock is a cash equivalent, letting go of the tax on the acquisition is a subsidy for corporate acquisitions, akin to an expenditure of government money. If any subsidy is going to be given to corporate acquisitions, it should be budgeted more carefully to discriminate between worthy and unworthy acquisitions.[37] It may well be that no subsidy would be given to acquisitions if the issue were put through the federal budget procedure.

Taxing publicly traded stock received in an acquisition is also natural given the increasing shift toward accounting for stock appreciation on a mark-to-market basis. Taxing the gain or loss on readily marketable stock annually as it arises would end all toll charges on a corporate acquisition by taxing the shareholder gain as it arose, whether or not the target shares were sold or exchanged in a reorganization. Since 1993, nontax generally accepted accounting principles have required that a corporation required to publish periodic financial statements to report the change in value of marketable equities, even if the assets are not sold during the reporting period.[38] If the perception underlying this proposal — that readily marketable stock is a cash equivalent — is applied consistently, tax would follow GAAP on this issue, and shareholders should always recognize the gain annually as it arises. The increase in value of easily sold shares is just like having more money in the bank. The taxpayer who has received $1,000 cash, still in his bank account, and the taxpayer who has a $1,000 increase in value, readily turned into cash by ordering a sale, are in the same economic position. This proposal does not apply the stock-is-cash principle beyond the subject of corporate acquisitions, but it should be viewed as consistent with and supporting the move to general mark-to-market taxation of publicly traded stock.

3. Simplicity. The current state of the law on acquisitive reorganizations is a briar patch of rules, accumulated over time by a combination of IRS rulings, judicial doctrines, and occasional congressional forays. Br'er Rabbit and tax experts paid by the hour may thrive in the

[37]Yany Brauner, ''A Good Old Habit, or Just an Old One: Preferential for Treatment for Reorganizations,'' 2004 *B.Y.U. L. Rev. 1* (2004), argues the tax incentives for reorganizations are inefficient because they favor both the good and the bad.

[38]Financial Accounting Standards Board, Financial Accounting Standard No. 115, ''Accounting for Certain Investments in Debt and Equity Securities,'' paras. 3, 13 (1993).

complexity of the briar patch, but the complexity is still unfortunate. Taxing publicly traded stock as a cash equivalent would take away much of the motive and engine for the complexity and simplify the law.

4. Need for revenue. The Congressional Budget Office recently estimated that the federal budget deficit for 2009 will total $1.6 trillion, or 11.2 percent of GDP.[39] The deficits do harm to the economy. Repeal of the nonrecognition for corporate acquisitions is a superior alternative to raising tax rates more generally. An increase in tax rates creates deadweight losses, above the revenue collected, by the square of the rate increase.[40]

C. Explanations of the Provision

The proposal would treat publicly traded stock as boot taxable to the shareholders, including corporate shareholders of the target. The target corporation would not be required to recognize gain on its assets by reason of a shareholder exchange or if it passed acquirer stock through to its shareholders. Publicly traded partnership interests would also be treated as cash equivalents. Publicly traded stock would also be boot when received in exchange for a transfer to a controlled corporation. The target corporation's issuance of stock would not be treated as a realization of shareholder gain under the proposal, and a shareholder would not be taxed when existing shares become readily tradable.

1. Shareholder tax.

a. Boot. The proposal would treat publicly traded stock received in a corporate acquisition as other property or boot. Under section 356, the boot would be allocated first to gain, taxable at capital gain rates, and after the gain is fully taxed, the boot would be recovery of the taxpayer's basis in the target shares. Section 356(a)(2) denies target shareholders use of their basis if a distribution has the effect of a dividend, but that will rarely apply because target taxpayers drop their fractional interest by more than 20 percent in going from ownership of the target to a share of the amalgamation.[41] The analysis behind this proposal, moreover, is that the acquisition is in substance a sale. A target shareholder who receives nothing but publicly traded stock and other boot would be able to recognize loss in the transaction.[42] Basis would be increased by the gain recognized under section 358, so that shareholders could soon sell the acquirer stock for its value on receipt without recognizing further gain or loss.

Reorganization nonrecognition would continue to be available for other transactions, such as mergers of closely held corporations, when the stock of the surviving corporation is not readily traded on an established market, even after the merger.

b. Sale restrictions. The acquirer stock would be taxable immediately, even if sale of the stock is restricted by contract or by corporate law. The acquirer stock is an investment that shares in appreciation, votes, dividends, and redemption proceeds even though it cannot be sold. In an income tax, amounts invested are subject to tax. Exemption from tax for the principal of an investment is a ''soft money'' privilege, which is ordinarily as valuable as permanent exemption from tax for the subsequent income from the investment during the deferral period.[43] Inability to sell prevents a shareholder from cutting off losses when stock declines, but it would be difficult to evaluate the loss in value caused by an inability to sell quickly. In an efficient market, for example, an investor generally cannot know whether the market has already digested bad news, so at any point gains must be considered as likely as losses.[44] Inability to sell also prevents a taxpayer from moving capital to another use, unless some creditor is willing to lend on collateral of the nonsalable stock. The proposal would ignore any discount to value resulting from a sale restriction because the shares would remain an investment that participates equally with unrestricted shares of stock in the appreciation, dividends, redemption proceeds, and votes. The simplicity of using a market price for shares identical to stock that is subject to sale restrictions or is held in a larger block makes the tax system more administrable and prevents tax deferral for the clear investment value of the stock, even as restricted. A tax system that depends on self-reporting and rare audits needs simple rules; it cannot handle subtlety or complexity.

Holding a large block of stock can amount to a sale restriction because a wise seller will dribble out sales of stock from that large block to minimize the impact on the market price. For the reasons given for ignoring explicit sale restrictions, the proposal would ignore any reduction in value due to the size of the block. A large block of stock does not prevent sale entirely; it merely suggests that sales should be spread out. Indeed, the value of votes increases as the size of the block increases. That is because the chances of influencing outcome increases, so there is less reason to allow a discount for ''blockage'' than for complete sale prohibitions.

c. Voting restrictions. No discount would be allowed for the absence of votes in a minority interest in the acquired corporation because votes of a minority interest are unlikely to determine the outcome of an election.

d. Publicly traded partnerships. The proposal would tax the receipt of an interest in a publicly traded partnership as a cash equivalent. It is the public trading that makes the interest a cash equivalent, not the formal nature of the business entity. Increasingly, the distinctions between partnerships and corporations are disappearing. Under the check-the-box regulations, an interest in a business entity can give limited liability to the taxpayer,

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[39]CBO, ''The Budget and Economic Outlook: An Update'' (Aug. 2009), *Doc 2009-19146, 2009 TNT 163-30*.

[40]*See, e.g.*, Joseph Stiglitz, *Economics of the Public Sector*, 376 (1986).

[41]*See* section 302(b)(2).

[42]*See* section 356(c), disallowing loss if there is some nonboot.

[43]Cary Brown, ''Business-Income Taxation and Investment Incentives,'' in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson*, 300 (1948), is the seminal work.

[44]Inability to sell is less valuable than a put option for the period the stock is not salable. A put option gives the holder the value of the decline in the current price of the stock below the sale price set by the put. The ability to sell does not preserve that value for the owner after the decline occurs, and the inability to sell does not lose that value.

be centrally managed, be freely alienable, and be of indefinite duration — and still be taxed as a partnership.[45]

2. Target corporation. Shareholder gain required by the taxation of publicly traded stock would be independent of target corporate-level gain. Corporate stock in a public corporation changes hands continuously, without effect on the corporation. This proposal would not force a corporation to recognize gain on its assets because control of the target corporation changes hands. The proposal treats the shareholder gain as an issue that the corporation need not be involved in. If a merger or asset acquisition qualifies as a reorganization, the target corporation would not recognize gain on its assets, and the acquiring corporation that ends up with the asset would carry over the target corporation's basis in assets, its positive earnings and profits, and other tax attributes.[46] To determine whether the acquisition qualifies for carryover basis and nonrecognition, the acquirer's stock would be treated as a continuity of interest for the common-law continuity of interest doctrine, even when the proposal would tax shareholders on the stock, considering it to be a cash equivalent.

Under current law, a target corporation can avoid tax on boot received in a reorganization by distributing the boot to target shareholders or creditors.[47] The proposal would continue the rule for both cash and the cash-equivalent publicly traded stock, thereby avoiding target corporation tax in a C reorganization.

3. Target issuance of stock. Change of corporate control can be accomplished by the target corporation issuing new stock to the acquirer in an amount that gives the acquirer the requisite control of the target. If the acquirer needs only 51 percent of the stock to gain voting control, the target can issue new shares to the acquirer constituting 51 percent of its shares after the issuance in exchange for acquirer cash or acquirer stock transferred to the target.[48] If the acquirer contributes appreciated assets, the acquirer corporation will need to acquire 80 percent of the target stock to avoid taxable gain on the transfer of the appreciated assets.[49] Acquisition of more stock for more assets should not be a loss, given that the stock is a fractional interest in the asset of a corporation that will be controlled by the acquirer.

When the acquisition of control is accomplished by the issuance of stock, target shareholders do not receive publicly traded stock — a cash equivalent — even when the acquiring corporation is publicly traded and accomplishes the acquisition using only its own stock. Under current law, the issuance of new stock is not a realization event to the historical shareholders who are surrendering control of their business.

It is concluded that the issuance of new stock by the target corporation need not be treated as a realization event to the target shareholders in the ordinary case. When change of control is accomplished by the issuance of stock, the target shareholders end up as minority shareholders in a subsidiary owned primarily and controlled by another company. A minority position in a subsidiary controlled by a public corporation is a terrible position. The subsidiary need not ever declare a dividend, and the board will be the elected agent of the majority shareholder with only minimal fiduciary duty to minority shareholders within the allowance of the business judgment rule. Minority shareholders get to share pro rata in dividends or liquidation proceeds without, however, being able to force either event. The stock cannot be sold on a public market, and it can be sold only to a party willing to walk into the terrible position of a minority shareholder in nonsalable stock. As long as that subsidiary stock is not separately traded on an established market, it is concluded, the shareholders have not received boot. However, the target corporation's distribution of publicly traded stock to its historical shareholders would be boot and yield taxable gain to the shareholders, even if done in the course of a reorganization.

4. Target shareholder's section 351. A corporate acquisition can be accomplished using section 351, which governs transfers to a controlled corporation. Control for section 351 transactions means 80 percent of the shares and votes of the controlled corporation.[50] The target shareholders contribute all their stock to a new consolidated corporation in conjunction with the acquiring corporation contributing enough cash, stock, or assets to gain whatever percentage of the consolidated corporation the acquiring corporation seeks. Because coordinated contributions count in determining whether transferors own 80 percent of the consolidated corporation, both the acquirer and the target shareholders can have nonrecognition of gain under section 351 even though neither alone has the requisite 80 percent of the stock of the consolidated corporation after the transaction.

It is proposed that publicly traded stock be treated as taxable boot when received in a section 351 transaction as well as in a section 368 reorganization. Sections 351 and 368 were born as separate paragraphs of the same statutory subsection, and they were nurtured by the same continuity of interest rationale.[51] Publicly traded stock is equally a cash equivalent, whether received in a transaction described by section 351 or by section 368.

Consideration was given to creating an exemption for nonacquisitive section 351 transactions. The proposal

[45]Reg. section 301.7701-3 (2006).

[46]Sections 362(b) and 381.

[47]Section 361(b)(1) and (3).

[48]The acquiring corporation does not need nonrecognition treatment if it is contributing cash because there is no gain to recognize. A corporation issuing stock never recognizes gain or loss on transfers of its own stock. Section 1032. Stock is nothing but the discounted present value of the dividend and redemption proceeds the corporation will make on the stock in the future; nonrecognition to the issuing corporation is thus akin to the rule that a borrower does not recognize gain by borrowing. Calvin H. Johnson, ''The Legitimacy of Basis from a Corporation's Own Stock,'' 9 *Amer. J. Tax Policy* 155 (1991).

[49]Section 351(a), incorporating section 368(c) (control is 80 percent of the stock).

[50]Section 368(c).

[51]*See* authority cited *supra* notes 2-4 and 14.

would automatically give an exemption for transfers within a controlled group of corporations, as defined by section 1551, because subsidiaries within the control group are not publicly marketable. Exemption is justified under current tax principles because in a control group the entire group is largely considered a single taxpayer, including as to recognition of gain or loss on transfers among the corporations. If a shareholder owns all the stock of a subsidiary, the issuance of more stock is a meaningless gesture, and if the contributing corporation controls the transferee corporation at the 80 percent level, the issuance of new corporate stock is *almost* a meaningless gesture. But subsidiaries, controlled at the 80 percent to 100 percent level requisite for section 1551, are not publicly traded, so the exemption from boot rules for receipt of nonpublic stock goes without saying.

Similarly, the proposal would automatically provide an exemption for the treatment of stock received as boot by a shareholder who owns all the shares of the corporation or stock received by a small group of investors, because neither wholly owned stock nor stock held by a small group of associated shareholders is listed on an established stock market. Tax-free reorganizations would continue to take place when the surviving corporation is not publicly traded. No further exemption from the proposal is needed.

5. Going public. Consideration was given to making public listing a tax recognition event, even when existing shareholders retain their same shares. Publicly traded stock is a cash equivalent, and shares in an illiquid, nonsalable business are not equivalent to cash. Thus, when the corporation writes a prospectus for its stock and the SEC allows the initial public offering, the shareholders move to achieve a cash equivalence that they did not have before. Going public is also commonly associated with a change of control, when most of the stock of the corporation is offered to the public. The difference between receiving new publicly traded stock and having old stock go public is subtle.

The decision whether to make going public a taxable event is deferred for future proposal. It is possible to repeal the corporate income tax and replace it with a very low-rate, more efficient tax on market capitalization. But the proposal would require taxation of the preexisting gain that arose in the shareholder's hands.[52]

[52]Calvin H. Johnson, ''Replace the Corporate Tax With a Market Capitalization Tax,'' *Tax Notes*, Dec. 10, 2007, p. 1082, *Doc 2007-26347*, *2007 TNT 238-36* (arguing that it will be necessary to tax preexisting built-in gain at the time of the initial public offering).