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TREASURY NEWS

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STATEMENT OF
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DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairmen and Members of the Subcommittees:

I am pleased to appear before you today to discuss some of the more significant Federal income tax aspects of corporate acquisitions. The recent surge in merger activity and the publicity surrounding recent acquisitions (and attempted takeovers) of large, publicly held corporations has renewed concern that our tax laws inappropriately encourage these transactions. We do not know all of the economic and other reasons behind the recent flurry of activity. However, we doubt that tax considerations are the driving force. We suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale, increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions; I will not today speculate on their decision making process, instead I will concentrate on the principal tax aspects of mergers and acquisitions and defer to the expertise of others on the effect of these corporate acquisitions on the economy as a whole.

While it is doubtful that our tax laws are primarily responsible for the recent merger upswing, they play an important role in these transactions, just as they do in virtually every business transaction corporations conduct. The subject of the hearing today concerns those aspects of our current tax laws that exert the greatest influence on merger activity. The first part of my testimony summarizes the different types of corporate acquisitions and describes the divergent tax consequences that may be obtained. The second part of my testimony discusses certain structural features of our tax system that appear to encourage corporate acquisitions and takeovers. The third part of my testimony describes recent trends in merger activity that raise significant tax policy issues. Included among these are the use of ESOPs in leveraged buyouts, the use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions and the carryover of tax attributes in mergers and acquisitions of thrift institutions. Finally, I will discuss certain legislative proposals that are inspired by the current wave of mergers and acquisitions.

I. Taxing Corporate Acquisitions - An Overview

In general, for tax purposes, corporate acquisitions are categorized into two basic forms -- taxable and tax-free. While this categorization vastly oversimplifies how the tax law applies to these transactions, it is useful in analyzing the important tax policy questions in this area to think of the transactions as coming within one of these two categories; for it is this categorization that will trigger the most significant tax consequences. This first part of my testimony summarizes the types of mergers and acquisitions that come within each category and their principal tax consequences.

A. Tax-Free Acquisitions

The distinctive characteristic of a wholly tax-free acquisition is that no gain or loss is recognized by the target corporation or its shareholders. The target shareholders are permitted to roll over their investment position in the target corporation for an investment position in the acquiring corporation without paying current tax. This tax-free rollover, however, is generally available only to the extent the target shareholders receive stock of the acquiring corporation or certain related corporations. Other consideration received by the target shareholders is taxable either as dividend income or capital gain, depending upon the application of a complicated set of judicial and statutory rules that strive to make this ever difficult distinction.

A tax-free acquisition generally will not generate taxable income to the target corporation, even if that corporation has appreciated assets. The corollary of this tax-free treatment is that the target corporation's historic tax basis for its assets "carry over" to the acquiring corporation and are not "stepped-up" (or down) to fair market value. Moreover, with certain limitations discussed below, tax attributes of the target corporation, such as net operating losses and unused credits and accumulated earnings and profits, will also carry over to the acquiring corporation.

To qualify as a tax-free acquisition, the transaction generally must qualify as a "reorganization" as defined in section 368 of the Code.*/ Although the statutory definition and judicial interpretations place significant constraints on how a reorganization can be structured, significant flexibility does exist. Thus, a tax-free acquisition can take the form of a direct acquisition of the target corporation's assets, the acquisition of the target corporation's stock, or a combination of the target and the acquiring corporation pursuant to statutory merger or consolidation.

B. Taxable Acquisitions

The principal characteristic of a taxable acquisition that sets it apart from a tax-free acquisition is that the seller in a taxable acquisition cannot receive a tax-free rollover of his investment. The seller in a taxable acquisition can be either the target corporation (a taxable asset acquisition) or the target shareholders (a taxable stock acquisition). The collateral consequences of a taxable asset acquisition and a taxable stock acquisition differ in so many respects that each will be discussed separately.

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*/ A "reorganization" is defined in section 368(a) as including four basic types of acquisitions: statutory mergers (type "A" reorganizations), stock-for-stock exchanges (type "B" reorganizations), asset-for-stock exchanges (type "C" reorganizations), and bankruptcy reorganizations (type "G" reorganizations). Tax-free acquisitions can also be effected through compliance with section 351. In addition to satisfying the statutory definition, a reorganization must meet certain other regulatory and common law tests (such as the "continuity of interest" and "continuity of business enterprise" tests) in order to qualify as a reorganization. Although there is some uncertainty regarding application of these statutory and judicial tests to particular fact patterns, there is a substantial body of case law and Internal Revenue Service rulings and past history that provide guidance to taxpayers.

1. Taxable Asset Acquisitions

In a taxable asset acquisition, gain or loss is recognized by the target corporation, unless, as discussed below, the target corporation is completely liquidated within a statutorily prescribed time. The sale may be reported on the installment method, however, in which case any capital gain is deferred and reported as the installment payments are received. In any case, the tax basis of the assets acquired are adjusted to reflect the purchase price paid for those assets. In a taxable asset acquisition, the acquiring corporation does not succeed to any of the target corporation's tax attributes, such as net operating losses and unused credits and accumulated earnings and profits. These tax attributes, however, will be available to offset the target corporation's income and tax liability resulting from the sale.

If a transaction is a taxable asset acquisition from a corporation that has adopted a plan for complete liquidation within a 12-month period, generally no gain or loss is recognized by the selling corporation (except to the extent of recapture and other tax benefit items). Gain or loss is recognized, however, by the shareholders of the liquidating corporation based upon the difference between the amount of the liquidation proceeds received and their stock basis. If the target corporation sells its assets for installment notes that are distributed in liquidation, the target shareholders can report their gain on the installment basis to the extent they receive the notes.

2. Taxable Stock Acquisitions

In General. If a transaction is a taxable stock acquisition, gain or loss generally will be recognized by the selling shareholders, but may be reported on the installment method if installment notes are received. The tax consequences to the target corporation and the acquiring corporation depend upon whether the acquiring corporation makes a section 338 election.

The immediate effect of a taxable stock acquisition is that the target corporation becomes a subsidiary of the purchasing corporation. If no section 338 election is made for the target corporation, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations discussed below. If a section 338 election is made, the taxable stock acquisition takes on most of the characteristics of a taxable asset acquisition from a liquidating target corporation.

Section 338 Elections. A section 338 election is available where one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. In such case,

the purchasing corporation may elect to adjust the basis of the assets of the target corporation as though the target corporation sold all of its assets to a new corporation in connection with a plan for complete liquidation within a 12-month period. The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/ A section 338 election requires that the target corporation generally recognize its recapture and other tax benefit items as if it had sold its assets pursuant to a plan of complete liquidation.

Section 338 also contains consistency rules designed to prevent a purchasing corporation from obtaining a step-up in basis for some of the target's assets, while preserving target's corporate tax attributes and historic tax basis for other assets. The typical case addressed by these rules is one where target has one group of high value, low basis assets with respect to which the purchaser wants to take depreciation, amortization, and depletion deductions on a stepped-up basis, and another group of assets which may carry either a significant recapture or other tax liability or valuable tax attributes (such as net operating loss or credit carryforwards). If the purchasing corporation were to acquire all of target's assets, all assets would receive a stepped-up basis, target (assuming target liquidated within a 12-month period) would be taxed only on the recapture and tax benefit items on all assets, and the corporate tax attributes of target would be extinguished. From a tax planning perspective, the purchasing corporation would like to step-up the basis of the first group of assets (for instance, by a direct asset purchase), yet avoid the recapture tax and maintain a carryover of basis for

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

the second group of assets and the valuable corporate tax attributes of target (by acquiring all of the target stock and not making a section 338 election).

To prevent this type of tax motivated tailoring acquisitions, the consistency rules require that the purchasing corporation must elect either to step-up the basis of all acquired assets (with the associated recapture and loss of corporate tax attributes) or to carry over the basis of all acquired assets (generally with the continuation of tax attributes). Section 338 generally provides that a step-up in basis (and attendant recapture and other tax consequences) will be triggered automatically if, within the period beginning one year before the beginning of the acquisition and ending one year after control is acquired, any member of the purchasing group acquires the stock of any corporation affiliated with the target corporation (target group) or an asset from any member of the target group, other than in certain defined transactions.*/

C. Carry Over of Corporate Tax Attributes

1. In General

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to carry back the loss to offset income earned in the three taxable years preceding the year in which the loss is incurred and to carry forward any excess to offset income earned in the 15 years after the loss is incurred. A net capital loss generally may be carried back to the three taxable years preceding the loss and then carried forward to the five taxable years succeeding the loss. The underlying premise of allowing a corporation to deduct a net operating loss or a net capital loss incurred in one year against taxable income earned in another year is to ameliorate the unduly harsh consequences of an annual accounting system. In other

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*/ The excepted transactions included transactions in the ordinary course of business, carryover basis transactions, pre-effective date transactions, and other transactions to the extent provided in regulations. In some cases, the consistency rules can operate to require taxpayers to take a step-up in basis and pay recapture taxes or suffer other tax detriments where no manipulative scheme exists. As contemplated by Congress in the Tax Reform Act of 1984, Treasury is considering allowing taxpayers to elect carryover basis (or cost basis when less than carryover basis in a particular asset) in all assets that a corporation acquires during the consistency period. We do not believe that the providing of this "carryover basis election" would create any significant new tax incentives for corporate acquisitions provided there are appropriate safeguards.

words, the ability to carry losses back and forward is intended as an averaging device. For similar reasons, corporations that are unable to use all their credits against tax in the year in which the credits are earned may use such excess credits to offset tax liability in the three prior taxable years and the 15 succeeding taxable years.

The ability to carry over net operating losses, unused credits, and other tax attributes following certain corporate acquisitions, as described briefly above, may affect such acquisitions in a variety of ways. The ability to carry over corporate tax attributes, for example, may affect both the form of acquisitive transactions and the price paid or the value of other consideration used in such transactions. Moreover, the ability to carry over tax attributes may in certain instances influence whether an acquisition will be undertaken. The ability to carry over tax attributes after a corporate acquisition, however, is limited under current law in several respects.

As mentioned above, the tax attributes of a target corporation generally survive a tax-free reorganization and carry over to the acquiring corporation. In addition, if a corporation acquires the stock of another corporation in a taxable transaction, the tax attributes of the target corporation also survive the acquisition, unless a section 338 election is made for the target corporation. Moreover, although a purchasing corporation that does not make a section 338 election will not succeed directly to the tax attributes of the target corporation, it may benefit from the target corporation's net operating losses, net capital losses, unused credits, and other tax attributes, if the target and purchasing corporations join to file a consolidated income tax return. Alternatively, a purchasing corporation that does not make a section 338 election may inherit the tax attributes of the target corporation if the target is liquidated or merged into the purchasing corporation.

2. Limitations on the Carry Over of Tax Attributes

Under sections 382 and 383, */ the ability of an acquiring or purchasing corporation to use or benefit from the net operating

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*/ Sections 382 and 383 were substantially amended in the Tax Reform Act of 1976, but the effective date of those amendments has been delayed several times. Most recently, section 61 of the Tax Reform Act of 1984 extended the effective date of the 1976 Act amendments until December 31, 1985. The 1976 Act rules, as well as current law, have been criticized and a number of reform proposals have been made. Although we understand that the Subcommittees are not examining sections 382 and 383 in detail at this hearing, we believe that it is important that Congress address these provisions this year and we look forward to working with the Congress in developing reasonable rules governing the carry over of corporate tax attributes.

losses and other tax attributes of a target corporation following a taxable stock acquisition or a tax-free reorganization may be limited. Sections 382 and 383 were enacted to establish objective tests that would curb "trafficking" in corporations with unused net operating losses and other favorable tax attributes. In the case of net operating loss carryovers, Congress was particularly concerned that profitable, operating corporations were acquiring shell corporations whose principal assets were unused net operating losses that could be applied against income of the acquiring corporations that was unrelated to the business activity of the acquired corporations.

In addition to the specific objective limitations provided by sections 382 and 383, the carry over of net operating losses and other favorable tax attributes may be disallowed under section 269, whenever the principal purpose of an acquisition of stock or assets is to obtain the benefit of losses, deductions, or credits. Thus, section 269 may be applied to deter misuse of the general carryover limitation provisions.

Finally, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited by the "separate return limitation year" and "consolidated return change of ownership" rules provided in applicable Treasury regulations. In addition to limiting use of net operating loss and credit carryovers, the consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition.

II. Structural Aspects of the Income Tax That May Encourage Corporate Acquisitions and Takeovers

While we believe economic as opposed to tax considerations typically drive a corporation's decision to acquire another corporation, we recognize that there are a number of structural features of our current income tax system that may encourage corporate acquisitions. The Committees may wish to consider removing or modifying some of the current law provisions that encourage merger activity. As the discussion below will indicate, however, some of the incentives in current law are rooted in the basic structure of how we tax corporations and their shareholders and could not be altered without fundamentally changing the present income tax system.

A. Double Taxation of Corporate Earnings

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income, and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends

are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating assets as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. The double taxation of dividends and the tax-free basis step-up at death operate in tandem to place extreme pressure on closely-held corporations to retain rather than distribute earnings.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt to equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate. The incentive for leveraged buyouts conferred by the more favorable tax treatment of interest payments is discussed further in part III.A.1., below.

B. Capital Gain - Ordinary Income Distinction

Currently, corporations are subject to tax on ordinary income at a maximum rate of 46 percent and on capital gains at a maximum rate of 28 percent. Individuals are subject to tax on ordinary income at a maximum rate of 50 percent and on capital gains at a maximum rate of 20 percent. While corporate taxable income distributed to individual shareholders as dividends generally bears two ordinary income taxes, the shareholder's receipt of cash or property in exchange for his stock in a purchase of the corporation results in a significant lessening of the double tax burden when compared with the receipt of such cash or property as dividend income. Even though corporate earnings distributed as dividends would be taxed to the shareholders at ordinary income tax rates, the gain attributable to retained earnings is taxed at preferential capital gains rates if the shareholders sell their stock. This capital gain opportunity results in an incentive for the corporations to retain income in corporate solution and for corporate acquisitions.

C. Underutilization of Capital Subsidies

Capital subsidies (such as certain credits and accelerated depreciation) provided through the tax system may have an unintended ancillary effect of encouraging mergers and acquisitions. In some cases the amount of these tax subsidies have outstripped the recipient corporation's ability to use them effectively by investing in operating assets. To the extent that a corporation cannot effectively reinvest the tax subsidies in operating assets, such amounts are invested in nonoperating assets, which stimulate merger activity as detailed in part II.A., above.

In addition, whenever a company does not have enough income and tax liability to benefit from the accelerated depreciation and tax credit capital subsidies, an incentive for mergers is created. As summarized earlier, there are limitations on the use of tax attributes of an acquired corporation, but these limitations do not apply to certain forms of mergers or acquisitions. And even in cases in which the limitations apply, the acquiring corporation may nevertheless benefit to some extent from the target corporation's tax attributes.

For example, the limitations provided in sections 382 and 383 generally would not apply if a corporation with substantial unused net operating losses and excess credits acquired a profitable target corporation's stock or assets in either a tax-free or taxable acquisition. Accordingly, income and tax liability generated by the target corporation or its assets could be offset in future years by the acquiring corporation's unused tax attributes. Similarly, if an acquiring corporation purchased the stock of a target corporation in a taxable acquisition and did not make a section 338 election, the acquiring corporation could use the target corporation's net operating losses to offset future income of the target corporation. If, on the other hand, the acquiring corporation made a section 338 election, although it would not succeed to the target corporation's tax attributes, any income realized by the target corporation by virtue of the section 338 election and the accompanying tax liability could be offset by the target corporation's net operating loss and credit carryforwards.

The ability to benefit from net operating loss and other carryforwards following the acquisition of a corporation is not necessarily inconsistent with sound tax policy. As discussed earlier, a corporation is allowed to carry back and carry forward its unused net operating losses and credits without limitation (other than on the number of carryback and carryforward years). These unused net operating losses and credits may result from capital subsidies to which the corporation is entitled, but is unable to utilize currently. The carry over of net operating losses and other tax attributes following a corporate acquisition may properly allow the target corporation to effectively benefit from the capital subsidies in the same manner as if no acquisition had occurred. Nevertheless, the tax rules governing the carry over of tax attributes should not encourage corporate acquisitions that would not be undertaken on purely economic grounds. Moreover, those rules should not result in tax attributes becoming more valuable in the hands of an acquiring corporation than they would have been in the hands of a target corporation.

In general, we believe that the existing limitations on the carry over of corporate tax attributes do not work well in some respects and improperly allow the carry over of tax attributes in some cases. We do not believe, however, that either the ability to carry over tax attributes in a corporate acquisition or the imperfections in the existing statutory and regulatory limitations on such carryovers is the fuel driving the recent surge of corporate acquisitions. Nevertheless, we do look forward to working with the Congress in reforming those rules this year.

We want to point out, however, that the existence of unused tax attributes and the ability to benefit from such attributes by acquiring control of a corporation would be of much less concern

if corporate taxable income were measured correctly and, for example, the existence of unused net operating losses meant that a corporation had realized actual economic losses. Under current law, however, a corporation that earns a significant profit may nevertheless have substantial net operating losses and other unused tax attributes. Current law does not provide for direct reimbursement of net operating losses or refundability of credits by the Federal government and does not permit corporations with unused tax attributes to transfer those attributes freely to other corporations that can benefit from them. The consequence of such a system is the existence of an increased volume of tax attributes that can not be used by the corporations to which they are made available. The lack of refundability or free transferability and the resulting increase in the volume of unused tax attributes place significant pressure on the rules that are designed to limit the use of net operating losses and excess tax credits following an acquisition and provide an incentive to acquire corporations with such unused tax attributes.

Moreover, the mismeasurement of income for tax purposes and the resulting increased volume of unused tax attributes may favor conglomeration by encouraging corporations that are engaged in business activities that generate "tax losses" and excess tax credits to combine with other corporations that are engaged in activities with fewer tax attributes. The tax laws should not create such a bias between diversified and non-diversified entities.

The adoption of a system that correctly measures economic income would eliminate the possibility that profitable corporations could have unused net operating losses or excess tax credits and would ensure that companies with loss carryforwards had suffered equivalent economic losses. The importance of rules limiting the use of tax attributes following corporate acquisition would thus be decreased. The proper measurement of corporate income also would greatly diminish the volume of unused favorable tax attributes, and correspondingly reduce the importance of tax attributes in decisions regarding corporate acquisitions and conglomeration.

D. General Utilities Doctrine

Some have argued that the section 338 rules and the liquidation rules conflict with the general scheme for taxing a corporation and its shareholders and may encourage corporate acquisitions. Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock with a section 338 election, there is a step-up in basis of assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the

rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336, and 337. Under those provisions, a corporation recognizes no gain (other than recapture and tax benefit items) on distributions, including liquidating distributions, made to its shareholders. These rules may give an additional incentive to a corporation to sell assets in some cases because it increases the likelihood that the present value of the tax benefits that accompany property ownership (e.g., depreciation and depletion deductions) may exceed the seller's tax detriment incurred on the sale. Thus, the same assets may be more valuable to a buyer than to the current owner.

Congress has reduced this incentive to sell corporate properties by limiting the scope of the General Utilities rule. For example, TEFRA made distributions of appreciated property in a partial liquidation taxable to the distributing corporation. In addition, the Tax Reform Act of 1984 (the "1984 Act") imposed the same treatment on dividend distributions of appreciated property. One major aspect of the General Utilities doctrine remains, however. Nonrecognition of gain by the selling corporation continues to be the general rule in connection with a complete liquidation and a deemed asset sale in connection with a section 338 election (although recapture and tax benefit items are taxed). While repeal of this last major exception would simplify the tax laws, we do not believe that the failure of the corporate tax regime to impose two levels of tax on liquidation transactions is primarily motivating corporate acquisitions. Further, as we have indicated in prior testimony before the Senate Finance Committee, we believe that in considering the repeal of General Utilities in liquidation transactions, relief from double taxation of liquidation proceeds must also be considered.

E. Inadequate Recapture Taxes

1. In General

Some have suggested that the imperfections in the current recapture rules may be a factor encouraging corporate mergers and acquisitions. If the General Utilities rule were fully repealed and a corporation were required to recognize gain to the extent the amount realized exceeds its basis in assets, the effectiveness of the recapture rules would not be as important. Short of a complete repeal of the General Utilities rule in a liquidation context, it may be appropriate to tighten current recapture rules. For example, under current law, a liquidating corporation that used the last-in first-out ("LIFO") method of accounting for inventories is required to recognize income attributable to the difference between the value of inventory determined on the LIFO basis and that determined on a first-in first-out ("FIFO") basis (commonly called LIFO reserve). This rule could be expanded to include all inventory profit (not just

the difference between LIFO and FIFO) and all other ordinary income. In addition, the recapture rules on section 1250 property (including residential real estate) could be conformed to the section 1245 recapture rules applicable to personal property to require the liquidating corporation to recapture ordinary income to the extent of the full amount of prior depreciation allowed. These changes would be premised on the notion that the corporation claiming tax benefits should return those benefits at the time of sale (whether by actual sale or in liquidation) if the sale shows that the earlier granted benefits were excessive.*/ Any strengthening of the recapture rules, however, magnifies the potential double taxation of corporate earnings and any change in the recapture rules should be coordinated with proposals to relieve that double tax burden.

2. Mineral Property

Under current law, gain on the disposition of mineral property is recaptured as ordinary income under section 1254 to the extent of intangible drilling costs that were deducted after December 31, 1975. There is no recapture, however, with respect to gains from the sale of mineral property for which intangible drilling costs were deducted prior to that date. Consequently, on the sale or exchange of mineral properties, gain attributable to expenses deductible against ordinary income as intangible drilling costs prior to 1976 is taxable at capital gain rates even though the drilling expenses were deducted against ordinary income.

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*/ It should be noted that recapture and tax benefit items generally are not recognized upon the sale of a subsidiary. However, such a result may be inconsistent with the basic principles of the recapture rules where the selling corporation and its subsidiary joined in filing a consolidated return for all years in which the deductions (or credits) were claimed. The consolidated return regulations provide for an annual basis increase (or decrease) in the parent's stock in the subsidiary based on the annual increase (or decrease) in earnings and profits, rather than taxable income, of the subsidiary for such year. Some have suggested that these rules may permit the selling parent corporation to understate its gain (as well as avoid recapture income) because the basis of the subsidiary's stock is inappropriately increased whenever the earnings and profits increase in an amount greater than taxable income. This disparity between earnings and profits and taxable income typically is due to certain tax subsidies, such as accelerated depreciation. The Internal Revenue Service takes the position that allowing this basis increase would result in impermissible double deductions to the selling affiliated group and is currently litigating this issue.

Prior to 1975 integrated oil companies could deduct percentage depletion at a rate of 22 percent with respect to mineral property. Percentage depletion deductions are not limited to the taxpayer's basis in the mineral property; so that, with respect to pre-1975 properties, the adjusted depletable basis (investment costs other than intangible drilling costs) for most taxpayers is zero. Since 1975, however, integrated oil companies have been required to use cost depletion. Thus, in effect, most integrated oil companies receive no depletion allowances if they continue to produce from pre-1975 properties. Upon a disposition of mineral property to another who would be allowed cost depletion for the same property, current law does not require recapture of either cost or percentage depletion allowances; this rule applies whether or not percentage depletion allowances were taken in excess of the taxpayer's basis.

Some have suggested that recapture rules should be applied to intangible drilling costs deducted in respect of mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by Congress in connection with legislation in 1976. Congress enacted a recapture provision at that time and settled upon what it considered to be a fair transition rule. We do not believe that it is appropriate to change that transition rule retroactively.

Suggestions also have been put forth to apply recapture rules to percentage and cost depletion allowances. Normally, as in the case of depreciable personal property, recapture of depreciation is provided when the property is sold or exchanged; only the excess of the selling price over original basis is eligible for capital gains rates (and nonrecognition at the corporate level in a liquidating sale). The lack of adequate recapture rules creates an incentive to sell to a buyer who will obtain the benefit of a step-up in basis (and therefore larger deductions against ordinary income) at the cost of only a capital gains tax to the seller. The failure to recapture cost depletion allowances thus may provide some incentive for acquisitions of companies with mineral properties. We do not believe the recapture rules applicable to mineral property should differ from the current recapture rules applicable to personal property. In either case, full recapture is needed to minimize inefficient churning of such property solely for tax reasons.

Although we would support full recapture of cost depletion, we would not support the application of recapture rules to percentage depletion. The percentage depletion allowance is, in effect, a negative excise tax on the production of minerals which results in a lower effective income tax rate for those eligible for its benefits. While it may be appropriate to consider reducing or eliminating future allowances for percentage depletion, we do not believe the special rate of tax on mineral properties that Congress provided by way of the percentage

depletion allowance should be retroactively repealed by extending the recapture rules. Congress dealt with the policy considerations involving the availability of this special tax incentive to integrated oil companies by limiting such taxpayers to cost depletion for taxable years ending after December 31, 1974.

III. Recent Developments in Corporate Acquisitions that Raise Significant Tax Policy Issues

The structural aspects of the current income tax law discussed above may encourage merger and acquisition activity to some degree, but as stated at the outset, we do not believe they are the driving force behind the current flurry of activity. A number of the publicized acquisitions that are of interest to the Committees involve tax techniques that have only recently evolved, and to some extent these techniques are based upon recently enacted tax incentives. We are concerned that these tax incentives are being employed in mergers and acquisitions in ways that Congress did not intend. Principal among our concerns are the use of ESOPs in leveraged buyouts and the carryover of tax attributes in mergers and acquisitions of thrift institutions. I would also like to comment upon the growing use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions.

A. Leveraged Buyouts and the Growing Use of ESOPs

1. Leveraged Buyouts

The prototypical leveraged buyout involves the conversion of a publicly held company into a private company pursuant to an acquisition by a newly organized private company of all of the target company's stock. The acquiring company usually is organized and controlled by the senior management of the target company. The private company's acquisition of the target stock is largely debt financed, with the expectation that the debt will be retired out of future earnings of the company.

As is the case with other mergers and acquisitions, we expect that leveraged buyouts are motivated primarily by economic factors. Nevertheless, the income tax law to some extent may encourage leveraged buyouts of corporations by the more favorable tax treatment of interest payments. As discussed earlier in part II.A., the deductibility of interest payments by a corporation compared to the nondeductibility of dividends encourages corporations to use debt rather than equity in financing operations or acquisitions because of the potential for double taxation of corporate earnings distributed as dividends.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages these acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expenses but no realization of the increase in value of the asset until its sale or disposition. In such cases the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern these Committees, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

The tax arbitrage from debt financing generally is available for all debt-financed assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with corporate acquisitions.

2. Leveraged Employee Stock Ownership Plans

While every leveraged buyout raises the concerns just noted, we have particular concerns about the use of leveraged employee stock ownership plans (ESOPs) to effectuate leveraged buyouts and to defend against attempted takeovers. Since Congress first

established special tax incentives for ESOPs, these plans have been used frequently in leveraged buyouts, but the 1984 Act makes ESOPs an even more attractive vehicle for purchasing shares in a leveraged buyout.

In a leveraged ESOP, the ESOP borrows to purchase stock of the company that establishes the ESOP, and the company obligates itself to contribute amounts to the ESOP sufficient to enable it to service the debt. The employer may deduct these contributions to the ESOP currently without regard to the restrictive limits on employer contributions to other types of employee benefit plans. Because the ESOP is a qualified plan, an employee participating in the ESOP is not required to include these contributions in income until he or she receives a distribution from the plan.

Under the terms of a typical leveraged ESOP, employees are not entitled to distributions from the plan until separation from service. When the ESOP distributes stock to a participant, the employee is taxed on the value of the stock (determined with reference to the price paid by the ESOP) and accumulated income which has been allocated to the participant's account. A participant has the right to require the employer to purchase the stock from the participant at fair market value, unless the stock is readily marketable and traded on an established securities market.

An ESOP is required to give covered employees the right to vote publicly traded shares held by the ESOP. But employees can vote shares held by the ESOP that are not publicly traded, only with respect to actions (such as mergers or liquidations) which require an affirmative vote of more than a majority of the corporation's shares.

It is possible that the nominal beneficiaries of the ESOP, the corporation's employees, will obtain little current benefit from the arrangement. This is true because, while the ESOP may own a significant percentage of the outstanding employer securities, a participant employee will not realize the value of the securities originally purchased by the ESOP until separation from service. Finally, because leveraged buyouts involve privately held corporations, the employees generally are entitled to only very limited voting rights with respect to ESOP stock.

Despite the uncertainty of the benefits that an ESOP confers on covered employees, in the 1984 Act Congress expanded the incentives for employee stock ownership through ESOPs in four ways: (1) banks, insurance companies, and other commercial lenders may exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock; (2) taxpayers are permitted to defer gain from the sale of stock to an ESOP if the proceeds are used to purchase stock in a second corporation; (3) corporations may deduct dividends paid to employees with respect to stock of the employer held in an ESOP or stock bonus plan; and (4) an ESOP may assume the estate tax liability with respect to stock of a closely held business which is transferred to the ESOP.

Historically, the employer's right to deduct ESOP contributions while the employees participating in the ESOP defer income has been a significant subsidy which has made the use of ESOPs a favored vehicle for leveraged buyouts. The 1984 Act, however, so enhanced the tax benefits available to leveraged ESOPs that we believe not only will the use of ESOPs in leveraged buyouts increase, but the total number of leveraged buyouts may actually increase. In addition, we expect that these new incentives will greatly increase the use of leveraged ESOPs to defend against potential takeovers.

The most significant of the new incentives for the use of ESOPs in leveraged buyouts is section 133 of the Code which permits banks, insurance companies, and other commercial lenders to exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock. This permits lenders to charge a lower interest rate and thus lower the costs of acquiring employer securities through an ESOP. We understand that the subsidy provided under section 133 allows qualifying lenders to provide financing to an ESOP at approximately 80 percent of the otherwise available interest rate. For example, if the rate available to the ESOP would be 10 percent without regard to section 133, the ESOP could save approximately $140,000 in interest charges on a ten-year, level payment, $1,000,000 obligation, assuming an actual interest rate of 8 percent. Such a significant reduction in the cash flow required to finance an acquisition is certain to stimulate leveraged buyouts.

The 1984 Act provisions also created an incentive for owners of businesses to sell to their ESOPs rather than to others. New section 1042 allows a shareholder to defer the gain on the sale of shares in the corporation to an ESOP if certain requirements are met. Presumably, the availability of deferral for a shareholder selling to an ESOP will result in a lower purchase price for the shares to the ESOP. Although our limited experience with this provision makes it impossible to know to what extent the special tax benefit to the selling shareholder will be reflected in the price to the ESOP, any reduction in the cost of acquiring a corporation through an ESOP will obviously create a further incentive for leveraged buyouts through ESOPs.

The cumulative effect of these subsidies is to create substantial tax incentives for leveraged buyouts through ESOPs. These benefits inure to those in a position to establish an ESOP and through that device to take a public company private. It also appears that ESOPs are frequently employed as a defensive takeover tactic. These tactics may have an unnecessary dampening effect upon otherwise advisable mergers and acquisitions. Although the goal of encouraging employee ownership may be worthwhile, we believe that any examination of mergers and acquisitions should include an examination of the effects on mergers and acquisitions of the indirect subsidies provided through the current tax provisions relating to ESOPs.

C. Overfunded Defined Benefit Plans

Concern also has been expressed recently about the involvement of overfunded qualified defined benefit plans in corporate mergers and acquisitions. Under current law, a company may terminate its defined benefit plan and receive any assets that are in excess of the present value of the participants' accrued benefits as of such termination. There are no restrictions on the company's use of such excess assets.

Because overfunded defined benefit plans thus constitute relatively attractive sources of cash, companies with significantly overfunded plans are thereby made more attractive takeover targets. There are several recent examples of acquiring companies terminating target companies' overfunded plans to partially fund the acquisitions. Also, it is not surprising that other companies have terminated their own overfunded plans to reduce the readily available pool of assets to which the companies have access and thereby to make themselves less attractive to other companies. These companies generally have used the excess assets to make less liquid investments (such as equipment purchases), to finance "going private" transactions, or to take defensive actions (such as establishing an ESOP to hold company stock) against potential takeover attempts. Finally, some companies have terminated their overfunded plans to use the assets offensively in their own takeover initiatives or to retire debt incurred in completed takeover transactions.

In assessing the role of defined benefit plans in mergers and acquisitions, one should understand the essential features of such plans and why and in what sense they are overfunded. The law grants favorable tax treatment to employer-maintained retirement plans that satisfy various qualification requirements. There are two types of qualified retirement plans: defined contribution plans and defined benefit plans. Under a defined contribution plan, a participant's accrued benefit is equal to the value of the assets allocated to such participant's account and all plan assets are allocated to participants' accounts. Thus, no assets are available for employer recoupment.

Under a defined benefit plan, however, the participant's accrued benefit is determined under a benefit formula, which generally is based on the participant's compensation and years of participation in the plan. The company maintaining the plan (the sponsor) has the responsibility to make sufficient contributions to the plan to maintain a pool of funds sufficient to provide the participants' promised retirement benefits as they come due. Accordingly, unlike a company maintaining a defined contribution plan, the sponsor of a defined benefit plan bears the full risk of investment gains and losses in the plan's assets.

There are numerous reasons why a defined benefit plan may, at any particular time, hold assets in excess of the present value of participants' accrued benefits at such time. The most basic reason is the inherent nature of the sponsor's obligation to fund a defined benefit plan, as reflected in the minimum funding standards of section 412 of the Code. These standards generally require that a sponsor fund the plan on a "going concern," rather than a "termination," basis. This means that sponsors must currently fund not merely accrued benefits, but also some portion of participants' projected benefits at normal retirement age. In projecting future benefits, future salary increases and inflation ordinarily are considered. In addition, in order to avoid an ever-increasing funding obligation as its workforce ages, a sponsor may choose to fund its plan in accordance with a level-funding actuarial funding method that tends to accelerate contributions relative to the rate of benefit accrual. As a consequence of the natural operation of the funding rules, a defined benefit plan that is not fully funded on a going concern basis may well be overfunded on a termination basis.

The actuarial methods commonly used in determining sponsors' defined benefit funding obligations rely on long-term assumptions regarding such items as investment returns and salary increases. To the extent that plan investments earn more than anticipated or salaries increase less than expected, overfunding will tend to be greater. For example, during recent years, the rates of return on equity investments have exceeded most actuarial assumptions, which themselves tend to be quite conservative, and salary increases have generally been less than expected.

Furthermore, in determining a defined benefit plan's excess assets, it is necessary to calculate the present value of participants' accrued benefits. The higher the interest rate assumption used in this calculation, the fewer assets are necessary to provide participants' accrued benefits. During recent years, insurance companies have been pricing both immediate and deferred annuity contracts for terminating defined benefit plans using recent high interest rates. By reducing the current cost of providing for participants' accrued benefits upon plan termination, this has contributed significantly to the excess termination-basis funding of many defined benefit plans.

Finally, within certain limits (section 404 of the Code), a sponsor is permitted to deduct defined benefit plan contributions in excess of the required contribution under the minimum funding standards. This may of course encourage further employer contributions to a plan, particularly in profitable years, and consequently larger overfunding.

The tax law requires a defined benefit plan to be maintained for the exclusive benefit of the participants and their beneficiaries. In addition, it must be impossible at any time

prior to the satisfaction of all liabilities with respect to the sponsor's employees and their beneficiaries under the plan, for any part of the plan's assets to be used for, or diverted to, purposes other than the exclusive benefit of the employees and their beneficiaries. Because it is not possible to satisfy all plan liabilities before plan termination, a sponsor may recoup plan assets only by terminating its plan. And, in this regard, because a sponsor may voluntarily establish a qualified plan and may voluntarily terminate its plan as it desires, this particular restriction rarely poses a practical obstacle.

A significantly overfunded defined benefit plan thus may be seen, both from the sponsor's perspective and from the perspectives of other companies that may be interested in attempting to take over the sponsor, as a relatively accessible and attractive pool of liquid assets. Of course, the desire to recoup excess plan assets is not limited to companies involved in merger and acquisition transactions. Any business need that requires significant financing--e.g., diversification, expansion of capacity, modernization, advertising--may be sufficient motivation. Nevertheless, due to the substantial cash requirements of acquisitions and acquisition-related transactions, it is natural that companies involved in such transactions will look to defined benefit plans as a potential source of ready funds.

While any assets received upon plan termination must be included in income, the sponsor is entitled to offset this inclusion by any available deductions and credits (including interest deductions and loss carryovers). Thus, because the decision to terminate is in the hands of the plan sponsor, it frequently is possible to time the termination so that none or only a small portion of the assets is subject to tax. To the extent a sponsor is able to achieve this result, terminating an overfunded defined benefit plan becomes more attractive.

One of the primary concerns expressed about the terminations of defined benefit plans to recoup plan assets is the security of the participants' benefits. Under current law, there is no requirement that participants continue to accrue benefits after a plan has terminated. It is thus inevitable that where a sponsor terminates a defined benefit plan and does not establish any other plan in its place, participants will not receive the benefits at retirement that they would have received--and may well have expected to receive--if the plan had not been terminated. In a voluntary pension system, there is very little that the government can do to prevent such terminations beyond assuring that all of the participants' benefits as of the termination are adequately provided.

Of greater recent concern, however, have been reversion transactions under which a sponsor receives plan assets while effectively continuing to maintain the defined benefit plan.

These transactions generally have taken two forms: (1) the termination of the defined benefit plan and the establishment of a new defined benefit plan, often identical to the terminated plan (reestablishment transaction); and (2) the spinoff of a defined benefit plan into two plans, one for active employees and one for retirees, the allocation of the excess assets to the retirees' plan, the termination of the retirees' plan, and the continuation of the defined benefit plan for the active employees (spinoff transaction).

In May 1983, the ERISA agencies (the Department of Treasury, the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation) issued enforcement guidelines (the Guidelines) for purposes of processing reestablishment and spinoff transactions. By requiring the full vesting of all benefits and the purchase of annuity contracts from insurance companies guaranteeing participants' accrued benefits, the Guidelines assure that the security of participants' benefits accrued before the transaction is not adversely affected. In addition, the Guidelines attempt to impose substantive parity between reestablishment transactions and spinoff transactions by requiring the continuing plan in the spinoff transaction to satisfy all of the substantive requirements of a formal termination--e.g., full vesting of benefits, formal notice to participants, and third-party annuitization of benefits. Moreover, the Guidelines extend additional security to plan participants in the continuing plans with respect to benefits accrued after the transactions by strengthening the funding requirements under such plans. Finally, the Guidelines prevent a sponsor from undertaking reestablishment and spinoff transactions on a regular basis by specifying that such transactions may not be undertaken more than once every fifteen years.

We believe that, within the confines of existing administrative authority, the Guidelines appropriately protect the interests of participants in plans that are involved in reestablishment or spinoff transactions. We recognize that some believe that additional protections are necessary, but we are comfortable that the Guidelines strike the proper balance between assuring the security of participants' benefits and not encouraging defined benefit plan sponsors to terminate their plans without establishing a successor plan. We do not believe that legislation with respect to these specific transactions is necessary.

Similarly, it is our view that the recent involvement of overfunded defined benefit plans in acquisitions and acquisition-related transactions does not warrant specific legislation to limit the rights of plan sponsors to terminate their defined benefit plans as they desire. We are concerned that any such legislative action to curb the termination of plans may

unnecessarily discourage employers from maintaining or properly funding defined benefit plans. We must be careful not to undermine the voluntary nature of the pension system in an attempt to dampen related merger and acquisition activity.

We recognize, however, that, in the context of a broader examination of pension and tax policy, it is appropriate to consider action to reduce the general incentive for plan sponsors to terminate plans and extract assets for nonretirement purposes. The impetus for any such action should not, however, be the involvement of overfunded plans in acquisition transactions--although this certainly would a factor to be considered--but rather should be based only on a full consideration of the applicable pension and tax policies. Thus, any proposal to reduce the incentive to terminate defined benefit plans should apply on an across-the-board basis, without regard to either the reason the sponsor is terminating the plan or the intent of the sponsor to establish a successor plan. For example, after further deliberations, it may be appropriate on pension and tax policy grounds to apply a special excise or minimum tax to asset reversions. This or similar action would reduce the attractiveness of terminating overfunded defined benefit plans in all circumstances.

D. Special Problems With Respect To Carry Over of Tax Attributes of Thrift Institutions

In the Economic Recovery Tax Act of 1981 ("ERTA"), Congress amended Section 368 of the Code to provide rules relating to bankruptcy reorganizations of thrift institutions (i.e., savings and loan associations and savings banks). These changes, proposed by the Federal Home Loan Bank Board (the "Bank Board"), were designed to resolve the issue of how the continuity of interest requirement applies in reorganizations involving thrift institutions.

Prior to ERTA, the Internal Revenue Service took the position that a merger of a stock association into a mutual association could not qualify as a tax-free reorganization. The Service reasoned that the exchange of the shareholders' stock for deposits in the mutual fails to satisfy the continuity of interest requirement because the deposits are cash equivalents. The courts generally rejected the Service's position, but without the concurrence of the Internal Revenue Service, combinations of stocks and mutuals could not be assured tax-free status.*/

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*/ The Supreme Court recently sustained the Service's position in Paulsen v. Commissioner, ___ U.S. ___, 105 S. Ct. 627 (1985), ruling that the merger of a stock into a mutual does not satisfy the continuity of interest requirement. In this case, which arose prior to ERTA, the Court held that the interests of the former shareholders of the stock association in the mutual were essentially cash equivalents and, thus, the transaction failed the continuity of interest test.

There was also uncertainty as to the application of the continuity of interest requirement in reoganizations involving thrifts under section 368(a)(1)(G) ("G reorganizations"). In many reorganizations involving thrifts, the transferor's solvency was in question and the Internal Revenue Service took the position that the transaction could qualify as a tax-free acquisition only if it satisfied the G reorganization requirements. However, it was not clear how the continuity of interest requirement applied in a G reorganization involving thrifts. In the case of a mutual association there are no stockholders and the principal creditors are depositors whose interests generally are insured and who are not likely to exchange those claims for stock. Further, stock associations were unwilling to issue stock to those depositors. Consequently, it appeared that the continuity of interest requirement generally barred the reorganization of a thrift from qualifying as a tax-free G reorganization.

To resolve these issues, Congress lifted the continuity of interest requirement in G reorganizations involving a transferor thrift if certain requirements are met. Generally, under these rules, a transaction otherwise qualifying as a G reorganization, in which the transferor is a financial institution to which section 593 applies, will not be disqualified merely because no stock or securities of the transferee are issued, provided: (i) the transferee acquires substantially all of the assets of the thrift and the thrift distributes any remaining assets pursuant to the plan; (ii) substantially all of the liabilities of the thrift (including deposits) become liabilities of the transferee; and (iii) the appropriate agency certifies that, under 12 U.S.C. §1464(d)(6)(A)(i), (ii) or (iii), either that the transferee thrift is insolvent, the assets of the thrift are substantially dissipated, or the thrift is in an unsafe and unsound condition to conduct business. The Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC") or, if neither has supervisory authority over the thrift, the equivalent state authority may certify that one of the grounds specified in 12 U.S.C. §1464(d)(6)(A) exists. In addition, section 382(b)(7)(B) was added to provide that the transferee's and transferor's depositors are taken into account in determining the level of continuity of interest for purposes of section 381.

In these acquisitions a profitable financial institution typically agrees to assume the transferor thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to succeed to the transferor's tax attributes. The tax attributes which the acquiring corporation seeks to preserve are the thrift's accumulated net operating

losses and other carryforwards and the transferor thrift's basis in its assets (typically residential mortgages with basis significantly above fair market value).*/

In tax-free reorganizations the continuity of interest requirement limits tax-free treatment to those transactions in which the owners of the target corporation receive a meaningful ownership interest in the acquiring corporation. The transfer of stock in the target corporation for stock in the acquiring corporation is tax-free because the owners of the target corporation are deemed to have merely changed the form of their investment. Moreover, the notion that tax attributes carry over in a tax-free reorganization hinges on the continuity of interest doctrine. The tax law considers it appropriate for tax attributes to be used to offset income earned after the acquisition whenever the historic shareholders who incurred the unused attributes continue to hold a sufficient equity position after the reorganization.

Under the revised rules for thrifts, neither the stockholders nor the creditors (i.e., the depositors) of the troubled thrift receive a continuing ownership interest in the acquiring corporation. To permit tax attributes to carry over in these transactions thus departs from the traditional principles underlying the tax-free reorganization provisions, and provides a tax subsidy for private acquisitions of thrift institutions. In effect, this subsidy may operate to shift some or all of the burden of thrift losses from FSLIC, the private insurance agency funded by the thrift industry, to the Federal government. Congress thus should consider carefully whether subsidies for the thrift industry are necessary, and whether they should be made through direct appropriations or through the tax laws, recognizing that the latter route may be less efficient and more costly in the long run. We recognize, however, that the thrift industry is undergoing a period of restructuring and there may be nontax considerations for encouraging the flow of capital into the thrift industry.

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*/ This carryover basis would leave the transferee with substantial built-in losses which could be realized merely by selling the loans. Alternatively, if the transferee does not sell the loans, the carryover basis permits the transferee to treat payments other than stated interest as repayments of principal; if the transferee took a fair market value basis in the loans, a portion of the "principal" repayments would constitute market discount under section 1277 and thus be treated as ordinary income.

Attachment A
(Continued)

Not Reviewed by the Office of Management and Budget
Due to Time Constraints

For Release Upon Delivery
Expected at 9:30 A.M., E.S.T.
April 22, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on three bills (S. 476, S. 420, and S. 632) relating to corporate acquisitions. These bills appear to be prompted by the recent surge in merger activity generally, but are particularly directed at hostile merger activity. The bills would substantially penalize, if not render economically impossible, mergers and acquisitions that are considered "hostile."

We do not believe that Congress should enact special tax provisions aimed only at hostile as opposed to friendly acquisitions. Indeed, we do not believe that Congress should amend the tax laws for the purpose of discouraging mergers and acquisition activity generally.

We do not know all of the economic and other reasons behind the recent flurry of activity. We doubt, however, that the tax laws are the driving force, but rather suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale,

increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions.

The bills that are the subject of today's hearing would discourage hostile takeovers by disallowing interest deductions with respect to certain indebtedness and mandating a section 338 election for certain stock purchases. In addition, the bills would discourage attempted takeovers by imposing an excise tax on certain profits realized by persons who take substantial investment positions in companies that are the subject of an attempted takeover. These profits have recently been referred to as greenmail profits. The bills also would clarify that under current law no deduction is available with respect to any greenmail payments.

The Treasury Department opposes these bills. As a matter of tax policy, we do not believe hostile acquisitions should be treated differently under the tax laws than friendly acquisitions, nor do we believe that a clear distinction can be drawn. Thus, we believe that interest deductions and section 338 elections should be equally available for hostile and friendly acquisitions. Further, we do not believe that certain gains from sales or exchanges of stock, labeled greenmail profits, should be subject to an excise tax. Finally, while greenmail payments are not deductible under current law, we would not be opposed to a statutory confirmation of this point.

Hostile Versus Friendly Acquisitions

All of the bills that are the subject of today's hearing would limit interest deductions, and both S. 632 and S. 420 would mandate section 338 elections, for all hostile acquisitions. Hostile acquisitions are defined in two different ways, however. S. 476 defines the term "hostile acquisition" generally as an acquisition of corporate property or stock by persons who have acquired a 20 percent or greater interest in the target corporation within the preceding year, if the transaction, before consummation, is not formally approved by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. No member of the board would be treated as independent if such member is an officer or employee of the corporation or was nominated by the persons making the acquisition.

Both S. 632 and S. 420, framed more broadly than S. 476, apply to acquisitions by any persons, if the acquisition is pursuant to a "hostile offer." The term "hostile offer" turns on the same factor as S. 476 -- disapproval by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. The

definition of an independent director is more restrictive under S. 632 and S. 420 than S. 476, as it not only excludes from the definition a person that is an officer or employee of the target corporation, but also any person that has substantial financial or commercial ties to that corporation, except for ownership of stock.

We do not believe the tax consequences of corporate acquisitions should turn on whether a corporation's independent directors approve or disapprove of the acquisition. Moreover, the effect of these bills would be to bring new and extreme pressure to bear on the decision making processes of independent directors. Because of the harsh tax consequences resulting from characterization of an acquisition as hostile, independent directors would in effect have a veto over corporate acquisition decisions. On the other hand, there may be substantial enough pressures on the independent directors that would, under certain circumstances, tend to make them vote for, rather than against, a proposed acquisition. For only by their favorable votes could the sanctions imposed by these bills be avoided. Such pressures would seem to undermine the very rationale for independent directors.

Further, many closely held corporations do not have independent members on their boards of directors. In such cases, the tax penalties could not come into play no matter how vigorously a takeover is resisted. The bills do not suggest any rationale for this arbitrary distinction. If these tax penalty provisions were enacted, however, companies would have an incentive not to have independent directors. We doubt that the sponsors of the bills intend such a result.

We believe very strongly that the market place (i.e., shareholders rather than independent directors) should determine whether a proposed acquisition is economically beneficial. The tax laws should not bias this decision towards friendly or against hostile acquisitions, as a hostile acquisition may turn out to be an economically beneficiary acquisition. Only a free market can make the optimal economic decision.

Disallowance of Interest Deductions on Certain Hostile Acquisitions

All of the bills before the Subcommittee limit the deductibility of interest incurred in connection with "hostile" takeovers. The genesis of these bills apparently stems from the publicity received by a number of recent acquisitions financed by the use of so-called junk bonds (i.e., high risk, high yield subordinated debt) and a concern that the current tax treatment of interest may encourage mergers, especially hostile acquisitions. The basic structure of our current income tax system may encourage corporations to utilize debt rather than

equity in financing operations or acquisitions because of the more favorable tax treatment of interest compared to dividends and the arbitrage potential from debt financing.

S. 476 would disallow a deduction for any interest paid or accrued during the taxable year with respect to "hostile acquisition indebtedness." Hostile acquisition indebtedness is defined as any "junior obligation" issued after February 18, 1985, in connection with a hostile acquisition. A "junior obligation" is any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by any person which, upon issuance, bears any one or more of the following characteristics: (1) the indebtedness is expressly subordinated to the payment of any substantial amount of unsecured indebtedness of the issuer or the corporation that is the target of the hostile acquisition, (2) the indebtedness is issued by a person whose assets are (or following the hostile acquisition would be) comprised predominantly of the stock of the target corporation, cash, and cash equivalents, or (3) the indebtedness bears a rating from any nationally recognized rating agency which is at least two ratings inferior to the rating from such agency in respect of any other substantial class of indebtedness of the issuer or the target corporation. S. 476 is effective with respect to interest paid or accrued with respect to obligations issued after February 18, 1985.

S. 632 differs slightly from S. 476 in that it disallows a deduction for any interest paid or accrued on indebtedness incurred or continued to acquire (or carry) stock or assets acquired pursuant to a "hostile offer." The definition of "hostile offer" differs only slightly from the definition of "hostile acquisition" in S. 476 as discussed above. S. 632 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock acquired after March 6, 1985. For assets acquired pursuant to a "hostile offer," S. 632 fails to provide a specific effective date for its application to indebtedness incurred or continued to acquire (or carry) such assets.

S. 420 is identical to S. 632 with respect to the disallowance of interest deductions, except that it does not apply to indebtedness incurred or continued to acquire (or carry) assets; it is limited to acquisitions of stock. S. 420 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock which is acquired after February 6, 1985.

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income,

and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may itself become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating asset as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. However, if the corporation is formed or availed of for the purpose of avoiding the second shareholder-level tax by permitting earnings and profits to accumulate instead of being distributed, there is imposed on the corporation a penalty accumulated earnings tax.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt-to-equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expense but no realization of the increase in value of the asset until its sale or disposition. In such cases, the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions also leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern this Subcommittee, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

One of the bills, S. 476, would deny deductions for interest paid on high yield, subordinated bonds used to finance hostile acquisitions. The concern generating the bill may have been that a number of these bonds, referred to as "junk bonds," have been used in connection with recent highly leveraged acquisitions. There is a substantial argument that some of these bonds would be more appropriately classified as equity rather than debt. Although there are significant differences in the tax treatment of debt versus equity, it is extremely difficult to develop general rules to differentiate a debt interest from an equity interest. Section 385 lists certain factors that are to be taken into account in distinguishing debt from equity interests. Although section 385 was enacted in 1969, to date no satisfactory general rules have been developed. The Internal Revenue Service has administered this area, and will continue to differentiate instruments including junk bonds, on a case by case basis. S. 476 does not consider any facts and circumstances other than those enumerated in its definition of junior obligation and, therefore, may inappropriately characterize some junior obligations as equity.

Two of the bills before the Subcommittee, S. 632 and S. 420, address the disparate treatment of debt and equity and the potential arbitrage from debt financing by limiting interest deductions on all indebtedness incurred or continued in connection with hostile acquisitions. The tax arbitrage from debt financing generally is available, however, for all debt-financed corporate assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest, we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with hostile acquisitions. Any tax advantage to utilizing debt in a corporate acquisition is available both to hostile as well as friendly acquisitions. We believe that any remedy to limit the advantage to utilizing debt rather than equity to finance corporate acquisitions should be done in a neutral manner.

Mandatory Section 338 Election in the Case of Hostile Stock Purchases

Two of the bills before the Subcommittee mandate that in a hostile stock acquisition, the acquiring company is deemed to have made a section 338 election for the target corporation, and that certain other provisions of the tax law that generally apply when a section 338 election is made, do not apply.

Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock subject to a a section 338 election, the acquiring company obtains the benefits of a step-up in basis of the acquired assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336 and 337. Under those provisions, a corporation does not recognize gain (other than recapture and tax benefit items) on certain distributions, including liquidating distributions, made to its shareholders.

The General Utilities rule applies when a section 338 election is made. The election is available generally whenever one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. If such election is made, the basis of the assets of the target corporation is adjusted in a manner similar to the adjustments that would occur if the target corporation had sold all of its assets to the acquiring corporation in connection with a plan for complete liquidation. The target corporation does not recognize gain (or loss) on such deemed sale (except for recapture and tax benefit items). The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

There is generally no requirement that a purchasing corporation make a section 338 election for the target corporation. If no section 338 election is made for the target, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations.

S. 632 provides that in the case of any hostile qualified stock purchase, the purchasing corporation will be treated as having made a section 338 election with respect to such purchase. In addition, all gain, not just recapture and tax benefit items, will be recognized on the deemed sale of assets. Moreover, the basis of the target's assets deemed purchased will be reduced by the amount of tax imposed on the target corporation as a result of the deemed sale. S. 632 is effective for hostile qualified stock purchases after March 6, 1985.

S. 420 is identical to S. 632, except that there is no requirement that the basis of target's assets deemed purchased be reduced by the amount of the tax imposed on the target corporation on the deemed sale. S. 420 is effective for hostile qualified stock purchases after February 6, 1985.

The availability of the section 338 election does not create any significant tax incentives for either hostile or friendly acquisitions. The provision was intended to facilitate mergers and acquisitions by permitting the acquiring corporation to replicate the tax consequences that would follow from an asset acquisition without requiring an actual sale and transfer of those assets. In many cases, however, the tax consequences of an actual asset acquisition or a deemed asset acquisition under section 338 will be adverse. Acquiring corporations have always been able to avoid such consequences by acquiring the stock of the target corporation and forgoing any adjustment in the basis of the assets of the target company. There are no tax policy considerations that suggest this latter alternative should be foreclosed to hostile takeovers. If a mandatory section 338 election were imposed, there would be a substantial bias in the tax law against hostile acquisitions of certain companies, especially those with large recapture and tax benefit items. We do not believe there is a sound tax policy reason for imposing that bias.

Similarly, we do not believe that there is any sound basis for imposing the additional tax penalties on hostile stock acquisitions that are proposed by S. 420 and S. 632. Whether all gains, not just recapture and tax benefit items, should be recognized on an actual liquidating sale of corporate assets or a deemed sale pursuant to a section 338 election, is not an issue that should turn on whether the acquisition is hostile or friendly. Finally, the reduction in basis for the tax liability generated on the deemed sale in a mandatory section 338 election

prescribed by S. 632 is contrary to fundamental tax concepts, and amounts to an awkward and ill-conceived penalty on hostile acquisitions.

Excise Tax on Greenmail Profits and Deductibility of Greenmail Payments

Although the bills, as discussed above, generally attempt to distinguish between hostile and friendly acquisitions, they also deal with so-called "greenmail" paid and received in either hostile or friendly situations. As the term is commonly used, greenmail refers to a payment made by a corporation to a particular shareholder, often referred to as a "raider," who has purchased a substantial amount of the corporation's stock as part of a plan to acquire the corporation.*/ The offer to purchase the raider's stock is usually not made to all shareholders and is thus known as "greenmail." In exchange for the payment, the raider sells his stock to the target corporation and agrees to refrain from further attempts to acquire the corporation (a "standstill agreement"). Although the payment is made in exchange for the stock surrendered by the raider, it also may include reimbursement for expenses incurred by the raider in the takeover attempt.

In an attempt to eliminate greenmail payments, S. 476 and S. 420 impose a nondeductible 50 percent excise tax on any person who realizes "greenmail profits." Although greenmail, as described generally above, commonly refers to payments made by a corporation to an unwanted shareholder, both bills would sweep more broadly. In particular, greenmail profits are defined under

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*/ Because shares of a publicly traded target corporation are readily available for purchase on a stock exchange and the raider is generally not required to disclose his intentions until he has acquired five percent of the corporation's stock, the existence and identity of a potential raider may not be known by the target corporation until the raider has acquired the threshold five percent. Under the Williams Act, owners of five percent or more of a corporation's stock are required publicly to disclose the amount of their ownership and their plans with respect to the corporation. Accordingly, neither the target nor the market may be aware of a takeover attempt until the raider has acquired a substantial amount of stock.

S. 420 to include any gain realized by a "4-percent shareholder"*/ on the sale or exchange of any stock in the corporation if (1) the shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. Under S. 476, greenmail profits also arise from a sale or exchange if, at any time during the two-year period, any 4-percent shareholder submitted a written proposal to such corporation which suggests or sets forth a plan involving a public tender offer, regardless of whether a public tender offer is actually made.**/

The tax would not apply, however, to a gain realized by any person on the sale or exchange of stock in any corporation if, throughout the 12-month period ending on the date of such sale or exchange, such person had been an officer, director, or employee of the corporation or a 4-percent shareholder. Under the bills, therefore, the 50 percent excise tax would generally apply to gains realized by relatively large, short-term shareholders. Both bills would be effective for sales and exchanges made after February 6, 1985, except for sales or exchanges made pursuant to a written agreement in existence on February 5, 1985.

The 50 percent excise tax proposed by both bills is deficient in several respects. First, the Treasury Department does not believe that any valid tax policy is served by subjecting greenmail profits to an additional tax. If greenmail payments are determined to be contrary to the public interest, they should be deterred directly, rather than through use of the tax laws. For example, state corporate laws could be amended to prohibit greenmail payments. Moreover, if such payments are judged by shareholders to be generally unacceptable, direct action may be taken. In particular, as many corporations have done, corporate charters may be amended to proscribe such payments.

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*/ Under both bills, a "4-percent shareholder" means any person who owns stock possessing four percent or more of the total combined voting power of all classes of stock entitled to vote. For purposes of determining whether a person is a 4-percent shareholder, stock owned both directly and indirectly (through the application of section 318) is considered.

**/ The term public tender offer is defined under both bills to mean any offer to purchase (or otherwise acquire) stock if the offer is required to be filed or registered with any Federal or state agency regulating securities.

In addition to the fact that the tax law is an inappropriate tool to deter greenmail payments, the technique adopted by the bills seems overly harsh and imprecise. Under current law, gains realized on a sale or exchange of stock are generally treated as capital gains. Assuming the shareholder had no capital losses, gains from the sale or exchange of stock held for six months or less are taxed as ordinary income at a maximum rate of 50 percent, while gains from stock held for more than six months receive preferential tax treatment. In particular, individuals and other noncorporate taxpayers may exclude 60 percent of the gain from income, and corporations are subject to a maximum rate of 28 percent on such gain. Under the bills, therefore, an individual shareholder who owned four percent of a corporation's stock for six months or less at the time of the sale could be subject to a 100 percent tax on any gain, a 50 percent ordinary income tax and the 50 percent excise tax.*/ The Treasury Department does not believe that such a confiscatory rate of tax is appropriate under any circumstances.

Moreover, we believe that a 4-percent shareholder, like any other investor, is subject to the vagaries of the market and should be taxed as any other investor. We perceive no tax policy rationale for taxing a larger shareholder at a higher rate than a smaller shareholder on an identical economic gain.

In addition, although the bills are styled as imposing an excise tax on "greenmail," their reach is much broader. In particular, the excise tax would apply to any investor who purchased more than four percent of a corporation's stock, regardless of whether the shareholder purchased the stock with an intent to acquire the entire corporation. Such large shareholders could include a variety of institutional investors, such as pension plans, college and museum endowment funds, and large private investors. While such investors normally hold stock for periods of longer than one year, and would thus be excluded from the excise tax under both bills, situations would arise in which such investors, who had recently purchased stock, would want to sell. These situations would include a variety of circumstances under which institutions may be forced to liquidate an investment for external reasons, as well as the simple desire

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*/ Even if the shareholder had held the stock at the time of the sale for more than six months, but less than one year, the gain could be taxed at 70 percent. Corporate shareholders, depending on the length of their holding periods, would be subject to maximum effective rate of either 96 percent or 78 percent.

to take advantage of appreciation caused by an actual or anticipated public tender offer. We do not believe that such investors should be subject to the punitive tax proposed by the bills.*/ While such large shareholders could avoid application of the excise tax by holding their stock for more than one year, such potentially noneconomic behavior should not be required by the tax laws.**/

The final class of persons who might be subject to the greenmail excise tax are so-called "arbitrageurs." Such investors often take relatively large positions in a corporation's stock in anticipation of a tender offer at a price in excess of the prevailing market price. While such an investor may seek to benefit directly from a raider's attempt to acquire control of a corporation, we do not believe that any tax policy justifies taxing such person at exorbitant rates.

In summary, the Treasury Department believes that S. 420 and S. 476 represent an imprecise and overly harsh response to a perceived problem that may not be a problem at all. In any event, the solution does not reside in the tax laws. Consequently, we oppose the excise tax provisions in both bills.

Focusing narrowly on the tax treatment of "greenmail" by the corporation, S. 632 provides expressly for the disallowance of a deduction for any "greenmail payment." A greenmail payment is defined by S. 632 as any payment made by a corporation in redemption of its stock from a 4-percent shareholder if (1) such shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. A greenmail payment also would include any payment to a 4-percent shareholder or other person for any expenses paid or incurred in connection with a redemption or public tender offer. Like S. 476 and S. 420, the term 4-percent shareholder does not include a person who holds at least four percent of the total voting power of the corporation's stock throughout the one-year period preceding the redemption or who was an officer, director, or employee of the corporation throughout that period. There is no specific effective date for these provisions in S. 632.

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*/ Even if institutions that are exempt from the income tax also were exempted from the excise tax, it would still fall inappropriately on some large taxable investors.

**/ The one year exception in the bill would permit a raider to avoid the excise tax simply by holding a four percent interest for one year. While business and other factors might preclude the use of such a tactic, the exception will diminish the effectiveness of the provision.

Under current law, the repurchase of stock by a corporation, regardless of the amount of stock owned by the shareholder from whom the stock is redeemed, is a capital transaction that can not give rise to a deductible loss and payments made by a corporation in such a transaction are not deductible.*/ Consequently, the Treasury Department believes that the provision of S. 632 denying a deduction for redemption payments made to a 4-percent shareholder under certain circumstances represents a limited restatement of current law principles.

S. 632, however, contains an exception for redemption payments made to a shareholder who, throughout the one-year period preceding the redemption, was an officer, director, or employee of the corporation or a 4-percent shareholder. Moreover, S. 632 does not apply to redemption payments made to a shareholder who owns stock possessing less than four percent of the voting power of all the corporation's stock. Because redemption payments are not generally deductible under existing law regardless of the size or identity of the redeemed shareholder, we believe that S. 632 is defective to the extent that it suggests that redemption payments made to such shareholders could be deducted by a corporation.

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*/ The courts have held repeatedly that an amount paid by a corporation to redeem its stock is a nondeductible capital transaction. See H. and G. Industries, Inc. v. Commissioner, 495 F.2d 653 (3d Cir. 1974); Jim Walter Corp. v. United States, 498 F.2d 638 (5th Cir. 1974); Richmond, Fredericksburg and Potomac Railroad Co. v. Commissioner, 528 F.2d 917 (4th Cir. 1975); Markham & Brown, Inc. v. United States, 648 F.2d 1043 (5th Cir. 1981); Harder Services, Inc. v. Commissioner, 67 T.C. 584 (1976); Proskauer v. Commissioner, 46 T.C.M. 679 (1983). In one isolated case, Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), a court held that an amount paid by a corporation to repurchase its own stock was a deductible business expense in light of a showing that liquidation of the corporation was imminent in the absence of the redemption, no value would have been realized by the shareholders upon such a liquidation, and the redemption represented the only chance for the corporation's survival. Regardless of whether Five Star Manufacturing was correctly decided, it has since been strictly limited to its unusual facts, see, e.g., Jim Walter Corp, supra, and its continuing vitality, even on those unusual facts, is unclear, see Woodward v. Commissioner, 397 U.S. 572 (1970).

Despite the clarity of existing law and repeated losses in litigation, some corporations engaged in takeover fights have apparently taken the position that redemption payments may be deductible for Federal income tax purposes on the theory that they are made to "save" the corporation. We believe that treating redemption payments as deductible expenses under the circumstances contemplated by S. 632 is inconsistent with existing law. Nevertheless, we would not object to an express statutory confirmation that existing law bars the deductibility of redemption payments. If such an amendment were adopted, however, it should expressly deny deductibility for all redemption payments, regardless of the size or status of the shareholder, and the accompanying legislative history should state clearly that the amendment does not create any inference that the Congress believes such payments are deductible under existing law.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

:tachment B

THE WHITE HOUSE

WASHINGTON

March 8, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Corporate Takeovers

There has recently been much attention focused on corporate takeovers and the need for any Federal legislation restricting such activities. A House subcommittee is currently holding hearings on takeovers and has asked the Administration to testify on March 12. This memorandum presents the Cabinet Council's findings on the value of takeovers and recommendations for an Administration position on possible Federal legislation.

Background

Mergers and acquisitions occur because of, among other factors, the belief that the combined company can operate more efficiently than two companies operating separately. In friendly mergers and acquisitions, which account for the overwhelming majority of such transactions, both parties agree on these benefits. In hostile takeovers, managers of the target company (the company being acquired) oppose the transaction because they: (a) fear the loss of their jobs; and/or (b) believe their shareholders would be better off if the company remained independent or merged with a different company.

In a hostile takeover, a bidder typically buys a significant percentage of the target company's stock and offers to pay other shareholders a premium for their shares. The bidder seeks to obtain enough shares, usually 51 percent, to gain control of the target company. The target management seeks to prevent the bidder from gaining control, typically through defensive tactics such as litigating against the bidder or buying the shares already owned by the bidder.

Last year, the Senate passed amendments to the banking bill restricting certain takeover activity, while the House considered, but did not pass, separate legislation. The Securities and Exchange Commission (SEC) proposed restrictive legislation last year, but recently indicated it will oppose such legislation this year. While there will be pressure from some segments of the business community for restricting bidder tactics and from stockholder groups for restricting defensive tactics, the likelihood in this session of Federal legislation restricting takeovers appears to be limited.

Principal Findings

The Cabinet Council on Economic Affairs has conducted a detailed study which examined two central issues: (1) the economic impact of takeovers and the extent of abuses; and (2) the appropriate Federal role, if any, in correcting these abuses. Based on this study, the Cabinet Council has approved recommending to you a statement of the Administration's position on corporate takeovers to guide Administration testimony on this issue. A copy of the proposed statement is attached. The principal findings of the Cabinet Council study are:

1. Corporate takeovers generally benefit the economy by enabling companies to achieve efficiencies, shift assets to higher valued uses, and police management conduct.

2. To the extent there are abuses in the takeover process, it appears shareholders need protection from the management of the target company, rather than from the bidding company. Because managers may primarily be interested in keeping their jobs, they may oppose a takeover bid that is in the best interests of the shareholders of the target company.

3. There is great capacity through the market, the States, and the courts to correct these abuses. There is no compelling evidence that these checks are inadequate. The market can react through changes in corporate charters. Institutional investors are starting to oppose target managements that resist takeovers. The States can pass laws governing abusive defensive tactics. The courts are able to distinguish between abusive and legitimate uses of defensive tactics by considering the unique facts of a particular case.

4. Only if there is a serious market failure of national dimensions should the Federal Government then consider taking appropriate steps to curb the potential for abuse. This position is shared by the chairman of the SEC.

The Council also considered the three major arguments made by critics of takeovers:

- Takeovers reduce competition. By reducing the number of competitors in an industry, takeovers increase the likelihood of higher prices than what a more competitive market would have produced.

However, the Department of Justice and Federal Trade Commission actively oppose mergers and acquisitions, whether friendly or hostile, that threaten to reduce competition.

- Takeovers financed by borrowing divert capital from more productive uses. When a bidder borrows bank funds for a takeover, it ties up money the bank could have lent to companies making "real" investments, instead of simply pursuing "paper profits."

Takeovers result in real benefits of greater efficiency, and not simply the pursuit of paper profits. Moreover, when a bidder buys shares in the target company, the funds are not diverted. The shareholders selling their shares to the bidder in turn invest these funds in the economy.

- Hostile takeovers force managers to focus on short-term protection against takeovers, rather than on long-term investments.

This argument overlooks the point that the best means of avoiding hostile takeover attempts is to maximize shareholder wealth, which reflects the long-term competitive prospects of the company. If the stock market does not think a company is making good long-term investments, the price of the company's share will fall, making it more vulnerable to takeovers.

Recommendation

The Cabinet Council on Economic Affairs unanimously recommends that you approve the attached Administration position on corporate takeovers.

Approve Ronald Reagan Disapprove _____

James A. Baker III
Chairman Pro Tempore

Attachment

PROPOSED ADMINISTRATION POSITION
CORPORATE TAKEOVERS

I. Corporate takeovers perform several beneficial functions and are generally good for the economy.

II. The Williams Act represents a compromise between the desire to afford target shareholders and managements adequate disclosure and a reasonable period of time in which to evaluate offers, and the needs of the competitive markets in securities and in corporate control to operate with a minimum of government regulatory interference. We have not seen sufficient evidence that the existing provisions of the Williams Act are inadequate to achieve their purpose.

III. Various limitations on bidder activities have been proposed, but a need for additional restrictions on bidders has not been demonstrated.

IV. Target company shareholders need and have protection from abuses by target managements in conjunction with contests for corporate control.

V. State law, enforceable in the courts, governs the permissible terms of corporate charters, management contracts, and managers' and directors' fiduciary obligations, each of which may serve to check management abuses. From existing state statutes and decisions of state and Federal courts, however, it is unclear whether state law is adequate to portect target company shareholders from abuses by target management. As new defensive tactics evolve, moreover, existing protections may prove inadequate.

VI. The balance between management's need to act expeditiously in the interest of the corporation and the shareholder's right to call that action into account should be resolved at the level closest to the problem and the relevant facts--by the corporation, its owners, and managers in the first instance; by state law, if necessary; and, by Federal law only as a last resort. If there is a serious market failure of national dimensions, then the Federal Government should consider taking appropriate steps to curb the potential for abuse. Otherwise, the Federal Government should take no step towards the establishment of Federal corporation law to govern relationships between shareholders and managers.

VII. While matters of corporation law have traditionally been the subject of state rather than Federal jurisdiction, the Federal Government should play an informational role by making public the best information about critical issues that shareholders are likely to face in many corporate change of control contests.

VIII. The Federal Government should also carefully consider the unintended effects that other Federal policy decisions may have on merger and acquisition activity. To the extent that these Federal decisions encourage more or less merger and acquisition activity than otherwise would have taken place in a free market, resources may be misallocated.