Legal Notes

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Note to Lodestar profs.

The attached may be of interest.

— Steve

New Tax Law Proposals Target Merger and Acquisition Transactions

By Alan Alpert and Russ Hamilton*

Congress is considering several tax changes that could adversely affect merger and acquisition transactions. Some of these proposals are outlined below.

Spin-Off Rules Tightened

Buyers and sellers frequently consider spin-off transactions in connection with mergers and acquisitions. In a typical tax-free spin-off, a parent corporation would distribute all the stock of its subsidiary to the shareholders of the parent. If the transaction met all the criteria for a tax-free transaction, neither the parent corporation nor its shareholders would be required to recognize taxable income.

One variation of the traditional spin-off involves the use of a spin-off to "sell" a subsidiary in a tax-efficient manner. The entity that wishes to acquire the subsidiary purchases an amount of parent stock equal to the value of the subsidiary stock. After a reasonable period of time (perhaps two years), the parent spins off the stock of the subsidiary to the new

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shareholder in exchange for the shareholder's parent stock. Assuming that all of the business issues associated with such a transaction can be successfully addressed while meeting all of the tax law requirements (i.e., business purpose test, active trade or business test, etc.), it is possible that neither the new shareholder nor the parent corporation would recognize taxable income on the transaction. (In contrast, if the parent corporation sold the stock of the subsidiary directly to the purchaser, the parent corporation would normally be taxable on the gain.)

The proposed change to the tax law would cause the distributing corporation to be subject to tax on any spin-off that resembles a sale. A transaction would resemble a sale if a shareholder who purchased stock within the last five years owns at least 50 percent of either the distributing or distributed corporation after the spin-off. In other words, for a spin-off to be fully tax-free, only shareholders who have held their stock for a substantial period can end up with control of either the parent or the subsidiary.

The proposed rules would apply for transactions that occur on or after October 10, 1990, but only if the shareholder acquired the stock on or after October 10, 1990. (This is the general effective date of this provision. Like other provisions discussed below, the effective date rule has several exceptions, including a "binding contract" exception that may allow transactions currently underway to avoid the new rule.)

Taxation of Debt Swaps Clarified

The current law that covers the taxation of certain debt-for-debt exchanges is unclear. For example, assume a corporation originally issued a $1,000 10-year debt security at par. The issuing corporation, now facing financial difficulty, convinces its debt holders to exchange their original $1,000 obligation for a new obligation with a face amount and a fair market value of $800. The current tax law is unclear whether the $200 of economic gain that the issuing corporation realizes in the debt swap should be treated as debt discharge income (generally subject to immediate taxation), or whether it should be treated as a reduction in the yield of the new obligation (generally resulting in $200 of reduced interest deductions over the life of the new obligation).

Corporations that are insolvent or under the jurisdiction of a bankruptcy court typically prefer to report the transaction as debt discharge income, since some or all of the debt discharge income is not taxable to them. Other corporations, however, frequently report the transaction to the IRS as a reduction of the yield of the new obligation, since that treatment defers the income tax detriment associated with the exchange.

The proposed law would clarify the tax treatment (but only prospectively) by providing that the transaction illustrated above results in immediate debt discharge income. Debt discharge income would also result if the face amount of the debt was not changed, but the yield was substantially reduced. The new rules would apply to exchanges taking place on or after October 10, 1990.

Preferred Stock Exchanges in Bankruptcy Workouts

Under current law, a corporation in a bankruptcy proceeding can extinguish debt by issuing stock (including preferred stock) and escape taxation on the debt discharge income that would normally result. In addition, the current tax law does not require the debtor corporation to reduce its tax attributes (such as net operating loss carryforwards, tax basis of assets, etc.).

The IRS recently held that the redemption price (not the fair market value) of the preferred stock is used to determine whether the corporation loses any tax attributes in a bankruptcy supervised swap. Thus, high face value, low yield preferred issues can help preserve a corporation's tax attributes.

For example, a corporation might issue preferred stock worth only $600 in exchange for $1,000 of its outstanding debt. If the transaction took place under the supervision of the bankruptcy court, the $400 of debt discharge income might have no adverse tax consequences to the issuing corporation.

In contrast, the issuance of new debt with a principal amount and value of $600 in a similar situation would result in $400 of tax attribute reduction to the corporation.

The proposed tax changes would treat certain preferred stock issued in bankruptcy workouts as debt, resulting in tax attribute reduction to the issuing corporation. The provisions would apply to preferred stock that has a stated redemption price, but only if the preferred stock has a fixed maturity date, is callable or is puttable.

The provision would generally be effective for exchanges occurring on or after October 10, 1990. These provisions would not apply to corporations that are under the supervision of a bankruptcy court in a proceeding that began before October 10, 1990.

Taxation of Holders of Preferred Stock

Currently, holders of preferred stock are taxable on actual cash and property distributions they receive with respect to their preferred stock (assuming that the corporation has adequate tax earnings and profits to support the dividend). In addition, a preferred stockholder can be taxed on the accretion of the "discount" of callable or mandatory redeemable preferred stock, if the discount is determined to be unreasonably large. For this purpose, the discount is the excess of the call or mandatory redemption price of the stock over the issue price of the stock.

Whether the difference between the issue price and the call redemption amount is large enough to require accretion is determined by the facts and circumstances associated with each instrument. (The regulations that cover this area allow, as a safe harbor, a 10 percent call difference for preferred stock that is not redeemable for 5 years.) The IRS has held that if the preferred stock is callable <u>at any time</u> by the issuer, the tax law does not require the accretion of any discount, even an unreasonable one.

The proposed tax law change would increase the number of situations in which preferred stock holders are taxable on accretion. The new rules would apply to mandatory redeemable preferred stock, as well as preferred stock that is puttable by the holder. The new rules also would apply to stock that is callable by the issuer, but only if the discount is not reasonable based on current tax law criteria. The new provision would generally be effective for preferred stock issued on or after October 10, 1990.

<u>Expansion of Corporate Equity Reduction Transaction Rules</u>

Usually, if a corporation generates a loss for tax purposes, the corporation can carry back the loss to the prior three tax years to generate tax refunds. If a corporation has been the subject of a corporate equity reduction transaction ("CERT"), however, the tax law can limit the amount of the carryback refund. A corporation that has experienced a significant increase in leverage either due to the payment of an unusually large dividend or due to a 50 percent change in ownership may be deemed to have been the subject of a CERT. The purpose of this rule, which Congress enacted in 1989, was to prevent corporations from generating tax refunds from prior tax years by increasing their leverage.

The original CERT rules do not apply to most subsidiaries that experience a 50% change in ownership. (If a subsidiary generates tax losses after its sale, the loss carryback refunds generally become the property of the consolidated tax return group of the seller, not the subsidiary or the buyer. Thus, the original CERT rules did not target losses generated by former subsidiaries, since it was believed that those companies would not benefit from the loss carrybacks.)

The proposed law would expand the scope of the CERT rules to apply to subsidiary corporations that experience a 50 percent or more change in ownership. The CERT limitation would not apply, however, if the tax law treats the acquisition as an asset, rather than a stock, acquisition.

The proposal would be effective for 50 percent changes in ownership that occur on or after October 10, 1990.

Pension Plan Reversions

If a pension plan is terminated and the excess assets revert to the employer, the current law imposes a 15 percent excise tax on the employer, in addition to the normal corporate income tax that would be due on the reversion amount.

Congress is considering several alternatives, including an increase in this excise tax rate to 20 percent. One proposal provides that if the employer does not establish or maintain a qualified replacement plan, the excise tax rate would rise to 50 percent. In order to avoid triggering this 50 percent rate, the qualified replacement plan would generally be required to receive at least 30 percent of the pension plan reversion.

This proposed change would generally be effective for reversions occurring after September 30, 1990.

Reporting Purchase Price Allocations

If the assets of a business are sold, the allocation of the purchase price can be important for both the buyer and the seller. The buyer, for example, will generally prefer to allocate as much of the purchase price as possible to assets that are rapidly amortizable or depreciable to maximize tax deductions. The tax law currently requires both the buyer and the seller to report to the IRS how they have allocated the purchase price among the assets transferred.

The proposal would clarify that the reporting rules do apply to stock sales that are treated as asset sales for tax purposes (also known as "Section 338 sales").

The proposal would also require special reporting for all stock sales in which a 10-percent or greater shareholder signs a covenant not to compete, or enters into an agreement that has a similar tax effect. (Buyers typically prefer to allocate a portion of the purchase price to covenants not to compete rather than to stock, in order to generate current tax deductions through the amortization of the covenant.)

Finally, if the buyer and the seller have agreed in writing on an allocation of the purchase price, the parties would be prohibited from taking a contrary position for tax purposes.

(The IRS, of course, would still have the opportunity to challenge the allocation of the purchase price).

These provisions would generally be effective for acquisitions on or after October 10, 1990.

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