Corporate Acquisitions and Divisions: Tax Issues

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SUMMARY

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Corporate Acquisitions and Divisions: Tax Issues

Corporate reorganizations (mergers and divisions) are eligible in some cases for nonrecognition of gains for tax purposes both at the corporate level and the shareholder level. The purpose of these provisions is to facilitate reorganizations that continue the business in a different form but with the same stockholders. A variety of restrictions apply to prevent abuse.

Mergers can be vertical (acquiring businesses in the supply chain), horizontal (with competitors or related businesses), or conglomerate (with unrelated firms). There are business reasons for both mergers and divisions, both aimed at increasing profitability.

A considerable body of research has been aimed at determining whether mergers increase profitability, whether that increase is from gains in market power or increases in productivity, and reasons mergers might take place even if they do not increase profits. While the findings are mixed, some evidence suggests that not all mergers are profitable and that, when they are, increased profits may be due to market power rather than gains in efficiency. This issue is important because, while efficiency gains are beneficial to society, gains in market power may benefit shareholders but harm the economy as a whole. Divisions do not raise market power concerns, but a major tax concern is whether they are used to distribute profits in a tax-favored way.

Mergers are estimated to account for about $2 trillion in value per year ($1.8 trillion in 2022); mergers of $1 billion or more account for 75% of the value, although only about 2% of the number of mergers. There is relatively little information about the size of divisions, but they appear to account for considerably less in value.

Mergers can be tax free if enough of the payment to the target corporation is in stock rather than cash or property and if substantially all of the assets of the target corporation are acquired. Statutory guidelines are often general, and specific guidelines are often in regulations. Divisions are tax free if they meet certain conditions designed to ensure that firms are continuing the same business with the same historical stockholders and are not using the division as a device to achieve more favorable tax treatment of distributions. Even in a generally tax-free reorganization, compensation in cash or property (called "boot") is taxable.

New taxes—such as the 15% corporate alternative minimum tax based on adjusted financial statement income and the 1% tax on stock repurchases—generally apply the same tax-free rules as the regular tax system, as does the global minimum tax (Pillar 2) proposed by the Organisation for Economic Co-operation and Development (OECD) and the Group of 20 (G20). Because the minimum taxes apply only when a firm has an effective tax rate below 15% and only to large firms, they create new tax consequences for mergers and divisions by changing the size of the firm and by blending or separating the minimum tax rates of firm activities.

From a policy perspective, a reason for retaining tax-free treatment is to remove tax barriers to mergers, and a reason for eliminating or restricting this treatment is to discourage mergers that mainly increase market power. Antitrust laws are a more focused method of achieving the latter, but many analysts view them as too narrow and ineffective. Divisions have been the focus of some relatively detailed proposals by academics, to simplify and reduce abuses.

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Introduction

Corporate reorganizations (mergers and divisions) are eligible in some cases for nonrecognition of gains for tax purposes both at the corporate level and the shareholder level. The purpose of these provisions is to facilitate reorganizations that continue the business in a different form but with the same stockholders. A variety of restrictions apply to prevent abuse.

Mergers and divisions are also important for the new corporate alternative minimum tax (CAMT), also referred to as the book income tax, and the new 1% tax on stock repurchases. They are also an issue in the proposed global minimum tax under the Organisation for Economic Co-operation and Development's (OECD's) Pillar 2. The CAMT and OECD minimum taxes, which are based on a measure of financial income, only apply to large firms and only affect firms with effective tax rates lower than 15%. They introduce new tax consequences for some mergers because they alter the size of the firm. In addition, a merger of a firm subject to the tax with another firm with a high effective tax rate can reduce the minimum tax paid. A division can increase the minimum tax.

Companies merge and divide for business reasons, although taxes may be a consideration. Mergers and acquisitions may be vertical (acquiring businesses in the supply chain, which may be cost saving), horizontal (acquiring competitors or related firms), or conglomerate (acquiring unrelated businesses). In some cases, mergers (primarily horizontal mergers) raise antitrust issues.[1] Companies may split up, for example, because some segments are mature and others are growing, attracting different types of investors. Split-ups may facilitate more focused management on each segment, and may make firm valuation more straightforward. Antitrust issues have also led to some split-ups, as was the case with AT&T in 1984.

The first sections of this report discuss the consequences and magnitude of mergers and divisions, and the remaining sections explain current tax treatment and issues and potential revisions that may be of interest to Congress.

Causes and Consequences of Corporate Reorganizations in Brief

Mergers have attracted more attention than divisions from the scholarly community, in part because they raise issues of anticompetitive effects, largely with respect to horizontal mergers.[2] Mergers can increase productivity by increasing economies of scale or providing improved products, which are beneficial to society. Mergers may also increase profits because of increased gains from market power, which is beneficial to shareholders but harmful overall to society.[3] Mergers may also fail to increase profits for a variety of reasons, for example by creating "diseconomies" of scale such as increasing the cost and difficulty of coordination. Research on

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[1] For additional discussion of antitrust issues, see CRS In Focus IF11234, *Antitrust Law: An Introduction*, by Jay B. Sykes; CRS Report R46739, *Mergers and Acquisitions in Digital Markets*, by Clare Y. Cho; and CRS Report R46875, *Antitrust Reform and Big Tech Firms*, by Jay B. Sykes.

[2] Vertical and conglomerate mergers can also result in anticompetitive effects. See Jeffrey Church, *The Impact of Vertical and Conglomerate Mergers on Competition*, Publications Office of the European Union, 2006, https://op.europa.eu/en/publication-detail/-/publication/d95d239c-2844-4c95-80a4-2181e85e8329, for a review.

[3] For a review of reasons for mergers as cited by chief financial officers, see Tarun K. Mukherjee, Halil Kiymaz, and H. Kent Baker, "Merger Motives and Target Valuation: A Survey of Evidence from CFOs," February 2005, at SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=670383.

mergers has addressed three issues: whether mergers increase profits, whether any increased profits are due to efficiency gains or exercise of market power, and reasons mergers might take place even if they do not increase profits. There is some dispute about whether mergers create value, although there is more agreement that a cash merger (where the firm is acquired for cash) is more likely to create value than a stock merger (where a firm's shareholders receive stock in the acquiring firm as compensation) in the long run.[4] A study by researchers at the Federal Reserve found that, in general, mergers resulted in increased profits because of monopoly power rather than efficiency gains.[5] Other researchers have made the case that mergers may create negative value but may increase compensation of executives.[6] Mergers have sometimes come in waves and concentrated in certain industries, and there is evidence that these waves may be due to shocks to the industry, particularly deregulation, as in the case of airlines.[7]

As discussed subsequently, taxes can discourage mergers (through taxation of cash payments) or encourage them (through acquiring firms with net operating losses), although one source of tax benefits—corporate inversions—has decreased in importance in recent years through tax law changes.

Divisions have generally not been subject to this degree of study and, in general, studies find that they enhance economic performance.[8] Some divisions spin off previous acquisitions; the major reasons cited in a survey include to increase focus or to divest a low-performing division.[9] Tax issues, however, have been more central to concerns about divisions as a device to distribute cash to shareholders in a tax-favored manner.

The Magnitude of Mergers and Divisions

Several organizations track data on the size of mergers, whereas data on divisions are limited. Although mergers or breakups of large firms are in the news, these types of reorganizations also involve small corporations which are probably not counted in most data.

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[4] See Geoff Meeks and J. Gay Meeks, *The Merger Mystery: Why Spend Ever More on Mergers When So Many Fail?* 2022, https://www.openbookpublishers.com/books/10.11647/obp.0309, which makes the case that most mergers create negative value; and Steve Kaplan. "Forget What You've Read: Most Mergers Create Value," *Chicago Booth Review*, 2016, https://www.chicagobooth.edu/review/forget-what-youve-read-most-mergers-create-value, which argues that mergers create value in the short run but that in the long run cash mergers tend to create value and stock mergers destroy value.

[5] Bruce A. Blonigen and Justin R. Pierce, *Evidence for the Effects of Mergers on Market Power and Efficiency, Finance and Economics Discussion Series*, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2016-82, 2016, https://www.federalreserve.gov/econresdata/feds/2016/files/2016082pap.pdf.

[6] See Geoff Meeks and J. Gay Meeks, *The Merger Mystery: Why Spend Ever More on Mergers When So Many Fail?* 2022, https://www.openbookpublishers.com/books/10.11647/obp.0309.

[7] Gregor Andrade, Mark Mitchell, and Erik Stafford, "New Evidence and Perspectives on Mergers," *Journal of Economic Perspectives*, vol. 15, no. 1 (Spring 2001), pp. 103-120.

[8] James E. Owens and Bruno E. Sergi, "The Ongoing Contributions of Spin-Off Research and Practice to Understanding Corporate Restructuring and Wealth Creation: $100 billion in 1 Decade," *Humanities and Social Science Communications*, vol. 8 (2021), https://www.nature.com/articles/s41599-021-00807-9.

[9] See Tarun K. Mukherjee, Halil Kiymaz, and H. Kent Baker, "Merger Motives and Target Valuation: A Survey of Evidence from CFOs," February 2005, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=670383.

Mergers and Acquisitions

The value of mergers and acquisitions in 2022 was $1.8 trillion, down from $3.1 trillion in 2021 (corresponding to 21,000 and 25,000 mergers and acquisitions, respectively).[10] The numbers for 2021 represented an unusually high year. The contraction in 2022 is also ascribed to the mid-year increase in interest rates. About 75% of the value in the last two years ending on March 31, 2023, was for mergers with values of $1 billion or more, and mergers were particularly pronounced in the technology and financial industries.[11] These $1 billion or more deals accounted for less than 2% of mergers, although there was a disproportionately high number of mergers in the same industries.

According to another source, there was $3.8 trillion in global mergers in 2022, with U.S. companies involved as either a target, acquirer, or both, accounting for 53% of merger value. Purely domestic accounted for 34.7% of merger value, U.S. acquirers of foreign firms was 10.6%, and foreign acquirers of U.S. firms was 7.7%.[12] Of the top 10 global mergers by value in 2022, U.S. domestic mergers accounted for 6 and U.S. acquirers accounted for 7.[13]

Both acquirers and targets of firms in mergers and acquisitions can be corporate or passthroughs, and in the case of acquirers, financial investors. Several types of entities can make acquisitions: existing corporations, private equity firms, financial investors, venture capitalists, and special purpose acquisition companies (SPACs).[14] The majority of acquirers are corporations, although this share varies over time.[15] While this discussion focuses primarily on corporate reorganizations, there are also rules that apply to partnerships and other flowthroughs.

An issue that is particularly important for tax purposes is whether the acquisition involved a transfer of stock, rather than a cash purchase.[16] Data indicate that stock is typically involved in about 30% of recent transactions (2017-2022).[17] A study of earlier transactions found that stock was involved in 65% of transactions from 1985-2015.[18] Cash may have recently been preferred because of low interest rates, if funds are borrowed to make the purchase. In general, cash

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[10] WilmerHale, *2023 M&A Report*, March 2023, https://www.wilmerhale.com/en/insights/publications/2023-manda-report. See also, "Value of merger and acquisition deals in the United States from 2006 to 2022," Statista, https://www.statista.com/statistics/420990/value-of-merger-and-acquisition-deals-usa/.

[11] Flashwire News Monthly, *US M&A News and Trends*, April 2023, https://go.factset.com/hubfs/mergerstat_em/monthly/US-Flashwire-Monthly.pdf.

[12] Calculations based on data in White and Case, "M&A Explorer," https://mergers.whitecase.com/.

[13] S&P Global, *Global M&A by Numbers, 2022 in Review*, https://pages.marketintelligence.spglobal.com/rs/565-BDO-100/images/global-manda-by-the-numbers-2022-in-review.pdf. The seven mergers in the United States (acquirer/target) were Microsoft/Activision Blizzard, Broadcom/VMwire, Elon Musk/Twitter, Kroger/Albertson Companies, Amgen/Horizon Therapeutics, Prologis/Duke Realty, and Adobe/Figma.

[14] SPACs are shell corporations formed through an initial public offering with the objective of acquiring or merging with an existing firm. See CRS In Focus IF11655, *SPAC IPO: Background and Policy Issues*, by Eva Su.

[15] Bain and Company, *Global M&A Report 2023*, https://www.bain.com/globalassets/noindex/2023/bain_report_global_m_and_a_report_2023.pdf.

[16] There is an extensive literature on the preferences for cash or stock in acquisitions. See David T. Brown and Michael D. Ryngaert, "The Mode of Acquisition in Takeovers: Taxes and Asymmetric Information," *The Journal of Finance*, vol. 46, no. 2 (June 1991), pp. 653-659; Robin S. Wilber, "Why Do Firms Repurchase Stock to Acquire Another Firm?" *Review of Quantitative Financial Accounting*, vol. 29 (2007), pp. 155-172; and Isabel Feito-Ruiz and Susana Menéndez-Requejo, "Mergers and Acquisitions Valuation: Cash vs Stock Payment," July 2013, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290954.

[17] Gauran Bhsin, "Cash Is King But Could Stock Rule In M&A Transactions?" *Crunchbase News*, May 3, 2022, https://news.crunchbase.com/business/stock-mergers-equity-cash-transactions/.

[18] Erik Lie and Yixin Liu, "Corporate Cash Holdings and Acquisitions," *Financial Management* (Spring 2018), pp. 159-173.

purchases are also preferred when an acquirer is closely held and shareholders do not want to lose control, or when the acquirer has a lot of free cash flow, reducing the need for borrowing. Cash transactions go faster and fall through less often. Cash is less likely with a large acquisition. Stock deals may be more likely when acquirer stock is overvalued because stockholders can exchange their overvalued stock for the stock of the target (acquired firm), although one study found that these acquisitions were motivated by CEO compensation.[19]

Divisions

Although breakups of large companies are in the news, smaller business also break up. One data source indicated that in the past decade there were $624 billion in new companies created in divisions, suggesting that these reorganizations are less important than mergers.[20] Breakups have increased recently, so this number may be larger. Some very large firms have recently completed or announced breakups (e.g., Johnson and Johnson, General Electric, and Kellogg).[21]

One reason for corporate splits is that investors prefer firms with more focus, which can allow shareholders to avoid a "conglomerate" discount. One study of spin-offs between 2005 and 2015 estimated that spin-offs gained firms over $200 billion in increased value.[22]

Mergers and divisions are related. Some breakups have resulted from prior conglomerate acquisitions that did not perform as well as expected; one source reported that 44% of mergers subsequently led to divestitures.[23] At the same time, firms that have spun off are likely to make acquisitions in the years shortly after the spin-off, and perhaps that is a motive for splitting off parts of the company. One study found that over 50% of firms that broke up cited future acquisition as a motive for the spin-off and 78% of spun-off firms made acquisitions within five years.[24]

How Mergers and Divisions Are Taxed Under the Income Tax

Mergers and divisions may qualify for tax deferral if they meet certain conditions. In general, this deferral is available only if securities are exchanged; any cash or similar payments (boot) is subject to taxation.

[19] Fangjian Fu, Leming Lin, and Micah S. Officer, "Acquisitions Driven by Stock Overvaluation: Are They Good Deals?" *Journal of Financial Economics*, vol. 109, iss. 1 (July 2013), pp. 24-39.

[20] TechSci Research, "Why are Major Conglomerates Suddenly Splitting Up into New Corporate Entities?" November 2021, https://www.techsciresearch.com/blog/why-are-major-conglomerates-suddenly-splitting-up-into-new-corporate-entities/261.html. This citation is a secondary citation to information provided by a data analysis firm, Factset Research Systems, and it is not clear what types of firms were covered.

[21] Reuters, "Factbox: Some of the Biggest Splits in Corporate America," June 21, 2022, https://www.reuters.com/business/some-biggest-splits-corporate-america-2022-06-21/.

[22] Marc Zenner, Evan Junek, and Ram Chivukula, "Shrinking to Grow: Evolving Trends in Corporate Spin-offs," *Journal of Applied Corporate Financ*e, vol. 27, no. 3 (Summer 2015), pp. 131-136.

[23] Henrik Cronqvist and Désirée-Jessica Pély, "Corporate Divorces: An Economic Analysis of Divested Acquisitions," July 31, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3662469.

[24] Mieszko Mazur, "Creating M&A Opportunities through Corporate Spin-Offs," *Journal of Applied Corporate Financ*e, vol. 27, no. 3 (Summer 2015), pp. 137-143.

A Note on Basis and Boot

Two concepts that are important to understanding the tax treatment of mergers and divisions are *basis* and *boot*:

- *Basis* is the value of property which determines the value for depreciation deductions or the amount excluded as a return of capital (and not subject to capital gains) when an asset is sold. Basis is generally what is paid for the asset, reduced by any depreciation deductions for physical assets. Depending on how the transaction is treated, basis may be the original basis in the hands of the acquired firm or the fair market value at the time of the transaction.
- *Boot* is the amount received in a transaction that is in cash or property, rather than securities. Boot is subject to tax even in generally tax-free transactions.

Mergers and Acquisitions

This section explains the general tax rules that apply to taxable acquisitions and the special rules that allow non-taxable acquisition.

Tax-free treatment of reorganizations that involve an exchange for securities dates back to 1918 and is thus a long-standing part of the tax code. The early rationale for this treatment was that it prevented taxation on what is essentially a paper transaction. At the time, proponents also argued the treatment was needed to encourage or at least not hinder beneficial changes in business organizations and economic growth after World War I. It was also justified as simplifying administration and compliance, including the liquidity problem if shareholders are subject to tax but do not receive the funds to pay the tax.[25]

Note that the type of transaction determines the basis of assets or stocks, and therefore for determining depreciation or capital gain if the asset or stock is sold.

Taxable Acquisitions

Acquisitions are of three basic types: a purchase of stock, a purchase of an asset, or a merger that takes place under state law (statutory merger). The parties are the purchaser (the acquiring firm), the target, and in some cases a subsidiary of the purchaser.

Note that under a general rule (Section 1032 of the Internal Revenue Code [IRC]), a corporation does not recognize gain in providing stock in return for assets (issuing stock). That is, when a corporation issues stock and sells it for cash to shareholders, no gain is recognized.

- **Stock Purchase:** In a stock purchase, the purchaser buys stock from the target's shareholders. The target's shareholders are subject to a capital gains tax and there are no tax consequences at the corporate level. The purchaser simply owns shares in the target company. To have control, it must purchase enough stock.
- **Asset Purchase:** In a purchase of assets, the purchaser exchanges its cash, property, or stock for some or all of the assets of the target. The purchaser can avoid taking on any undesired liabilities by purchasing only selected assets of the company. Cash and property are called boot and the entire purchase price can be in cash. The target company pays tax on the difference between the purchase

[25] Steven A. Bank, Mergers, "Taxes and Historical Realism," *Tulane Law Review*, vol. 75, no. 1 (November 2000), pp. 1-86.

price (including any liabilities assumed) and the target's basis. The purchaser's basis is the fair market value of the assets. To the extent that shares are used to purchase assets, shareholders of the target receive shares of the acquiring company. Cash may be used by the target company to repurchase shares or make cash payments. If the target company is liquidated, its shareholders pay capital gains tax. If the company continues, a stock redemption or repurchase is taxed as a capital gain, and direct cash payments to the target's shareholders are taxed as a dividend.

- **Statutory Merger:** In a taxable merger, the two firms are combined and the target does not survive. State laws guide statutory mergers, which generally require shareholder approval. The merger can be taxed as an asset purchase in the case of a direct merger of the target into the purchaser or the merger of the target into a subsidiary of the purchaser (called a forward triangular merger). The merger can also be treated as a stock purchase if a subsidiary of the purchaser merges into the target (the target receives consideration for its stock, and the subsidiary's stock is converted to new target-issued stock, called a reverse triangular merger). Mergers using a subsidiary have the advantage of shielding the parent from any unknown liabilities.

Under IRC Section 338, an election (i.e., a 338(g) election) can be made to treat a stock purchase as an asset purchase, which means that the target pays tax on the gain of the deemed asset sale and the purchaser has a new basis as the fair market value of the assets. This election might be beneficial if the target has net operating losses to offset the tax and depreciation for the purchaser increases due to the higher basis. (A stock acquisition generally preserves the preexisting attributes of the firm, such as net operating losses, while an asset acquisition does not.) A Section 338(h)(10) election can also avoid tax at the shareholder level if the acquired corporation is a subsidiary of another corporation.

Section 351 Transaction and Section 357 Debt Assumption

Section 351 provides that a transfer of property to a corporation in exchange for stock will not be taxed if after the transaction the transferor is in control of the corporation (the transferor must have at least 80% voting stock and other stock). Gain will not be recognized and the basis of the property will generally be the same in the corporation's hands. If boot is received from the corporation, it will be taxed up to the amount of gain on any appreciated property and basis may be adjusted. This section might be used to form an initial corporation or to create a subsidiary and is thus not so much a merger as a change in organizational form.

If debt is assumed by the corporation, it is treated as boot and a tax will apply up to the gain (this rule is in Section 357). Because of the rule treating the transfer of debt in excess of basis as taxable income, unincorporated businesses that become corporations by swapping the business's assets for stock in the corporation may generate a tax liability if they have debt and a low basis in assets.

Tax-Free Acquisitions

The rules for tax-free treatment for both acquisitions and divisions are generally contained in Part III of Subchapter C of the IRC, in Sections 354-368. They relate to both the treatment at the corporate level and the treatment at the shareholder level and apply to reorganizations as defined in Section 368. If the reorganization qualifies for the tax-free reorganization rules, taxes are deferred on some gains.

Sections 354, 356, and 358 govern the treatment of the target's shareholders. Section 354 provides that gain or loss will not be recognized to the target's shareholders if the reorganization is the exchange of stock. (Section 355 relates to divisive reorganizations.) Section 356 provides that when some money or property (boot) is received, the recipient will be taxed on the boot up to the amount of gain. Section 358 provides that the shareholder's basis will remain the same.

Sections 361-362 govern the treatment of tax in an asset purchase. The target is not subject to tax on appreciation of assets and the purchaser takes on the target's basis in the asset in a qualified reorganization.

Section 368 defines the term "reorganization" and in the process lays out a series of rules governing types of reorganizations that qualify for tax-free treatment in Section 368(a)(1). The treatment is not always completely tax free, as stockholders of the target corporation may pay some tax. This section lists seven types of reorganizations, A-G. All of these apply to acquisitions, but type D can also apply to divisions. E, F, and G are specialized. E and F involve only one company, in E exchanging one type of security for another (e.g., bonds and stock), and in F changing the company's name, location, etc. G relates to corporations in bankruptcy.

- **Type A:** This type is a statutory asset acquisition merger that takes place under state laws, which generally require shareholder approval by at least a majority vote. The purchaser acquires all of the target's assets and liabilities. Among other requirements, it has a continuity of interest requirement to receive tax-free treatment, which has been determined by the Internal Revenue Service to require at least 40% of the payment to the target for its assets to be in the form of stock of the purchaser. In a qualifying merger, there is no tax on the target corporation (Section 361) as long as property received is distributed, and the purchaser keeps the original basis (Section 362), the stockholders of the target pay tax on the lesser of boot or gain (Section 356), and they retain their basis in the target company stock (Section 358). Forward triangular mergers and reverse triangular mergers are also allowed under Sections 368(a)(2)(D) and (E), although reverse triangular mergers require that stock constitute 80% of the compensation.
- **Type B:** This merger exchanges stock of the purchaser for stock of the target, with the purchaser controlling the target after the merger. No boot is allowed, and no taxes are incurred at either the firm or shareholder level. A Section 338 election is not allowed.
- **Type C:** This merger is also an asset acquisition, but the purchaser does not have to acquire all of the target's assets and liabilities. The requirement, under an IRS-created safe harbor, is to purchase at least 70% of the gross assets and 90% of the net assets; lesser amounts may qualify depending on the facts and circumstances. The purchaser must provide consideration of at least 80% voting stock. (If the target has substantial liabilities that are assumed, 100% of the payment in voting stock may be required.) The target distributes stock, compensation, and any remaining assets to shareholders. Tax treatment is the same as a Type A merger. This type of merger allows firms to avoid certain liabilities of the firm that may be uncertain.
- **Type D (Acquisitive):** This merger is similar to C, but the voting stock requirement does not apply. However, after the merger, the target corporation's shareholders must own more than 50% of the stock of the purchasing corporation (i.e., they control it), which would require use of voting stock to achieve that purpose. (This plan is also qualified under Section 354.)

- **Type E:** An E reorganization is not a merger but an exchange by a corporation of one type of security for another (i.e., a "recapitalization").
- **Type F:** An F reorganization is not a merger but a change of identity, form, or place of organization.
- **Type G:** Type G relates to a merger in a bankruptcy proceeding, where assets are distributed to shareholders in a transaction that otherwise qualifies for tax-free treatment.

Asset purchases that are eligible for tax-free treatment also carry over attributes of the target firm, such as net operating losses. These attributes are listed in Section 381(c), although the rate at which net operating losses are taken into account is limited under Section 382. This limit is based on a rate of return multiplied by the target's assets.

Special Rules for International Mergers[26]

Transfers of property to foreign corporations in a merger are subject to tax under Section 367. This rule applies because once transferred, the property can be sold and otherwise escape U.S. tax indefinitely. A special provision for the transfer of intellectual property provides for ordinary income tax on a stream of payments representing the asset's earnings.[27]

Until 2006, type A mergers were not available for international mergers because they had to take place under state law; regulations subsequently extended type A mergers to foreign transactions.[28] Before that time, international asset mergers were largely limited to type C reorganizations, which are more restrictive as to the form of payment made for property (that is, stricter limits on the amount of boot).

One tax motive for international mergers—allowing firms to change headquarters to take advantage of lower tax rates, called inversions—has been restricted through several tax code and regulatory changes beginning in 2004, when the tax code was revised so that any inverted firm where the U.S. shareholders owned 80% or more of the combined firm would be treated as a U.S. firm. Any 60% to 80% mergers would not be allowed to use net operating losses or foreign tax credits to offset the tax. These changes meant that there was an incentive to merge with a foreign firm in order to achieve the inversion. This motive is not related to the direct tax treatment of mergers as much as other characteristics of the international tax system.[29]

Current Requirements and Limitations of Tax-Free Acquisitions

In addition to the statutory requirements, there are other conditions arising from court decisions or regulations. The purpose of these conditions is to ensure that the historical shareholders of the target firm continue to have an interest in the same business and that the merger not be equivalent to a sale. There are basically four requirements.[30]

[26] Note that shareholders pay tax in inversions, where the U.S. firm becomes part of a foreign parent.

[27] Before P.L. 115-97, often referred to as the Tax Cuts and Jobs Act, there was an exception for property used abroad, but the legislation eliminated that exception.

[28] See U.S. Department of Treasury, *Statutory Mergers and Consolidations*, T.D. 9242, January 26, 2006, https://www.irs.gov/pub/irs-regs/td_9242.pdf.

[29] See CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

[30] See Michael L. Schler, "Basic Tax Issues in Acquisition Transactions," *Dickinson Law Review*, vol. 116, iss. 3 (2012), pp. 879-911, https://ideas.dickinsonlaw.psu.edu/cgi/viewcontent.cgi?article=4017&context=dlra, for a brief (continued...)

Continuity of Interest

Continuity of interest concerns arose in court cases, and detailed conditions regarding continuity of interest are in the regulations, which include the basic requirement that 40% of the consideration received by the target shareholders is in the form of stock of the acquiring company. There has been a continuing issue about whether and under what circumstances the target shareholders could subsequently sell their shares while maintaining tax-free treatment, but current regulations do not impose any requirement and probably could not do so for widely held firms whose stock is frequently traded.

Continuity of Business Operations

The acquiring corporation must continue to operate a historical line of business of the target or use a significant portion of the target's assets in business. The examples given in regulations suggest that operating one of three historical lines of business or using a third of the assets will meet the qualifications.

Business Purpose

The acquisition must have a business purpose outside of benefitting shareholders. This test is generally easily met.[31]

Subsequent Transfers of Assets

Generally, assets cannot subsequently be transferred outside of the corporate group, although there can be transfers if they do not cause the continuity of interest test not to be met.

Divisions

Distributions in General (Without Tax-Free Treatment)

Tax on Corporations

In general, a distribution of stock of a corporation to its shareholders does not result in a tax to the corporation, but a distribution of appreciated property (including stock of other corporations) is subject to a tax on the gain at the firm level. This treatment means that for a distribution of appreciated property, the tax treatment is the same as if the firm sold the property and distributed cash. Treatment of corporations is contained in IRC Sections 311-312.

Tax on Shareholders

The tax rules for shareholders are contained in IRC Sections 301-307.

A distribution of a corporation's stock is not income to shareholders and a distribution of property is taxed as a dividend. If the dividend exceeds the earnings and profits of the corporation, any excess reduces the basis of stock, and any additional excess is taxed as a capital gain.

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discussion beginning on p. 899; see also Mark J. Silverman, *Continuity of Interest and Continuity of Business Enterprise Regulations*, Practicing Law Institute, May 2014, https://www.steptoe.com/a/web/2946/4763.pdf.

[31] This is a general doctrine arising from a Supreme Court case, *Gregory v. Helvering*, 293 U.S. 465 (1935). It is more important for corporate divisions.

If a corporation redeems (or repurchases) its stock, the shareholder is treated as if the stock were sold and taxed as a capital gain (the purchase price less the shareholder's basis), unless it is considered equivalent to a dividend. A series of provisions addresses circumstances where the distribution is not treated as a dividend. For example, a series of cash payments that redeems a portion of each shareholder's stock could be a dividend, whereas a purchase of shares in the open market would be a capital gain. Since capital gains and dividends are currently taxed at the same rates, the advantage of capital gains treatment is that tax applies only to amounts in excess of the basis (original cost to the shareholder). If the redemption is liquidation of a firm, the distribution is treated as a capital gain.

Separating a Business When Taxable

Under these rules, without the special tax-exempt provisions under IRC Sections 355 and 368, the following results would occur if a firm wished to separate into two businesses.

If the business is not contained in an existing subsidiary, the firm can distribute assets to shareholders, which results in a tax to the corporation on gain and a dividend to shareholders. (This approach would only work in a closely held corporation.) Alternatively, it can sell the assets directly, pay capital gains tax, and then distribute cash to stockholders, who pay tax on the dividend.

A firm can create a subsidiary without tax consequences if it exchanges property solely for the shares of the corporation (Section 351) as long as it is in control of the subsidiary (at least 80% of the voting stock and at least 80% of all other stock). If it receives cash or property (boot), it is subject to tax on the boot up to the amount of the gain.

If the firm has a subsidiary or creates a subsidiary, it can sell shares in the subsidiary to the public, pay gain on the stock sale, and distribute cash to shareholders as a dividend. Alternatively, assuming it does not qualify under Section 355, it can distribute the stock to shareholders or exchange the stock for stock of the distributing firm, and the general rules for tax on distributions apply (dividends treatment on a distribution of stock and capital gains on an exchange of stock).

Tax-Free Divisions (Qualifying Under Section 355)

The purpose of a tax-free division, in general, is to allow a division of a business among existing shareholders, so that those existing shareholders as a group continue to own the firm (although these shareholders may have different ownership of different parts of the firm). A firm can transfer stock of a subsidiary to its shareholders tax free if it meets the requirements of Section 355. If it already has a subsidiary, the rules of Section 355 apply (i.e., no tax to shareholders and, in exchanges, shareholders allocate basis between the shares proportional to market value for the purpose of future sales). The firm can also create a subsidiary under Section 368(a)(1)(D) and immediately distribute the stock under a plan of reorganization that meets the requirements of Section 355 with no tax to either the firm or the subsidiary. In general, gain is not recognized to the corporation for subsidiary stock, subsidiary securities, or boot if boot is passed on to shareholders or creditors under certain circumstances. If assumed liabilities exceed the basis in the asset, gain will be recognized, and if boot exceeds the basis of the assets minus debt assumed, boot will be taxed to the firm. The firm must own 80% or more of the shares of the subsidiary before the distribution and shareholders must own at least 80% after the distribution.

Distributions fall into three types.

Spin-off

In a spin-off, the firm distributes stock of the subsidiary to its shareholders on a pro rata basis. Shareholders allocate existing basis between parent and subsidiary shares based on fair market value. If boot is included, it is taxed as a dividend.

Split-off

In a split-off, the corporation distributes shares of the subsidiary to its shareholders in exchange for its own stock. It does not have to be pro rata. Any boot is treated as a stock redemption (subject to capital gains tax).

Split-up

The firm creates two subsidiaries and distributes the shares to shareholders, with the parent company liquidated. Boot is taxed as a stock liquidation (capital gains).

Current Requirements and Limitations of Tax-Free Division

The tax-free division is designed to allow a business to be separated into parts while still maintaining control by its existing shareholders. To qualify as tax free, a number of conditions must be met, some in the tax code and some in regulations, as many of the conditions are general in nature.[32] Most of the requirements in Section 355 were long-standing, dating from spin-off rules that were first adopted in 1924, and then rescinded in 1934 over concerns that the provisions allowed shareholders to convert dividends into capital gains. Spin-offs were once again allowed in 1951, but with provisions that the active trade or business must be carried on and the division not be used as a device for distributing earnings and profits (the device restriction). In 1954, a control test was added, and the provision was largely unchanged until the elimination of a general ability to transfer appreciated assets to shareholders without paying a corporate-level tax (referred to as the *General Utilities* doctrine) in 1986.[33] This repeal led to a series of related reforms to Section 355. One article suggests that the combination of taxing dividends at the same rate as capital gains and the repeal of *General Utilities* means the focus of abuse in Section 355 moves

[32] Several articles discussing the history and issues associated with Section 355 provide additional background. Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr, provides a history and discussion of the issues. George K. Yin, "Taxing Corporate Divisions," in that same issue, Article 10, responds to Mr. Schler, https://scholar.smu.edu/smulr/vol56/iss1/10/. Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr, focuses on reforms related to the repeal of *General Utilities*. Herbert M. Beller, "Section 355 Revisited: Time for a Major Overhaul?" 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232960, discusses the history of Section 355 and proposes reforms. In addition to these articles that analyze legal principles, articles that discuss the rules include Gregory N. Kidder, "Basics of U.S. Tax-Free Spinoffs Under Section 355," *International Taxation*, vol. 5 (November 2011), pp. 438-447, https://www.steptoe.com/images/content/2/6/v1/2630/4358.pdf; Elizabeth P. Zanet, "Tax 101: How to Structure a Corporate Division," Ruchelaw, *Insights*, vol. 2, no. 19 (2015), pp. 44-49, http://publications.ruchelaw.com/news/2015-12/InsightsVol2no10.pdf; and Robert W. Wood and Donald P. Board, "Spin-Offs Under Code Section 355," *The M&A Tax Report*, vol. 24, no. 7 (February 2016), http://www.woodllp.com/Publications/Articles/pdf/Spin-Offs_Under_Code_Sec_355.pdf.

[33] This phrase refers to a 1935 Supreme Court case, *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). A drafting error in the 1987 legislation was amended in 1988. See Mark J. Silverman and Lisa M. Zarlenga, *The Section 355(d) Regulations: Narrowing the Scope of an Overly Broad Statute*, Practicing Law Institute, https://www.steptoe.com/images/content/2/2/v1/2211/3591.pdf.

from a concern about transforming dividends into capital gains treatment (the focus of the device restriction) to not allowing it to be used to avoid the *General Utilities* repeal.[34]

Some requirements are statutory and some are contained in the regulations. The first two are in the regulations, and the remainder in the statute, although also addressed in more detail in regulations.

Business Purpose

The regulations specify that Section 355 applies only if the division is carried out for a business purpose.[35] This provision is defined in the regulations following a Supreme Court decision in 1935 that found it was not sufficient for a division to meet the statutory requirements for tax-free treatment, but there must also be a business purpose.[36] While business purpose is not precisely spelled out in the regulations, examples given include separating a risky from a less risky business, or separating into businesses that different shareholders want to focus on, leading them to be more efficient.

Continuity of Interest

These regulations also require that the shareholders of the original corporation must retain interests in both corporations after the distribution, that is, neither corporation can be immediately sold after the distribution. The preexisting stockholders must maintain some minimum equity interest. There is no specific bright line in the regulations, although examples indicate that 20% is not enough and 50% is enough to satisfy the requirement. There is also no specific time period for these requirements, although the Internal Revenue Service has indicated that five years would be sufficient, while advisors suggest two years, and courts have allowed periods shorter than two years.

Control

Corporations are required to be in control (80% of voting power and 80% of all other shares) of the subsidiary before the distribution of stock or the exchange of stock, and shareholders are required to be in control after the distribution.

Device Restriction

The distribution must not be used as a device to distribute earnings and profits. This provision relates to the historic concern that led to spin-offs being disallowed in some periods in the early tax law, because of the use of spin-offs to make distributions that were dividends, with money then realized by selling the stock with a capital gains treatment. This rule was more important when dividends were not taxed at favorable capital gains rates. Capital gains treatment remains beneficial since basis is deducted from capital gains but not dividends.

The test is a subjective facts and circumstances test with standards in the regulations, and it weighs the factors for and against a device. Factors indicating a device include a pro rata distribution of stock, a sale of stock after the distribution, assets not used in a five-year trade or business, and a secondary business that could be sold without adverse effects. Evidence against a

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[34] Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr.

[35] 26 C.F.R. §1.355-2—Limitations.

[36] *Gregory v. Helvering*, 293 U.S. 465 (1935).

device includes a strong corporate business purpose, stock of the company is publicly traded and there are no shareholders with more than a 5% share, and shareholders are corporations that would be entitled to a dividends-received deduction.

The device test is aimed at the treatment of distribution to shareholders and adopted prior to the repeal of the *General Utilities* doctrine.

Active Business Requirement

Both the distributing firm and its subsidiaries must carry on an active trade or business after the division. This active trade or business must have been carried on for the five years preceding the division (included in this amount is the purchase of a business in the same line, the business expansion rule). The trade or business could not have been acquired in the previous five years by a taxpayer who recognized gain. Control of the corporation could not have been acquired by a distributee (shareholder) corporation or the distributing corporation within five years where gain or loss was not recognized. This last requirement was put in its current form in 1987 (Section 355(b)(2)(D)). This change was to prevent a firm from recently purchasing the distributing firm for cash (and thus having a high basis) and then allocating part of that basis to subsidiary stock in a spin-off and selling the shares while recognizing little or no gain.

Part of the active business requirement's purpose is to prevent businesses from separating their inactive businesses (such as holding of stock and securities) from their active business. There has been concern about the active business being a de minimis part of total assets (5% or even less), and proposed regulations in 2016 provided some specific rules as to what ownership shares would be considered as evidence of a device or as evidence of a nondevice.[37] These regulations proposed a minimum of 5% of active business assets. In addition, evidence that there is no device would be if both the distributing and controlled corporation each had 20% nonbusiness assets or if the difference between the two was less than 10 percentage points. Evidence of a device would be if two-thirds of assets were nonbusiness or if there were certain disparities between the shares of the distributing and controlled firm.[38]

Disqualified Distribution

This provision (Section 355(d)) was added in 1990 after the repeal of *General Utilities*, and expanded the scope of circumstances where corporation-level tax is imposed after the 1987 revision. It imposes tax on the gain to the corporation on a distribution if, immediately after the distribution, a shareholder holds a 50% interest in either the distributing or the controlled corporation that is attributable to stock purchased within the five-year period before the distribution. Subsequent regulations are argued to have significantly limited the scope of Section 355(d).[39]

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[37] See Internal Revenue Service, "Guidance Under Section 355 Concerning Device and Active Trade or Business," 81 *Federal Register* 46004, July 15, 2016, https://www.federalregister.gov/documents/2016/07/15/2016-16512/guidance-under-section-355-concerning-device-and-active-trade-or-business.

[38] For a summary of these proposed regulations, see Paul Weiss, "Treasury Proposes Changes to Tax-Free "Spin-Off" Rules," https://www.paulweiss.com/media/3643168/21jul16tax.pdf.

[39] Mark J. Silverman and Lisa M. Zarlenga, *The Section 355(d) Regulations: Narrowing the Scope of an Overly Broad Statute*, Practicing Law Institute, 2010, https://www.steptoe.com/images/content/2/2/v1/2211/3591.pdf. The authors argue that the scope of Section 355(d) is overly broad. This article also has a detailed discussion of the regulations.

Morris Trust Rule

Section 355(e) was added in 1997 to address transactions where the spin-off is followed by the acquisition of 50% of the distributing corporation (Morris Trust transaction) or of the spun-off corporation (reverse Morris Trust transaction) by another corporation.[40] Under this section, gain will be recognized at the corporate level if the acquisition takes place within two years before or after the spin-off, although this treatment can be rebutted (called a rebuttable presumption). There are a number of complex regulations governing whether Section 355(e) applies. While these provisions followed highly publicized transactions, some critics argued that this type of transaction was the only way to eliminate unwanted businesses when two corporations decide to merge. Section 355(f) disallows tax-free treatment of shareholders in an intragroup transaction if Section 355(e) applies.

Section 336(e) Election

A provision was added in 1986 authorizing the Department of the Treasury to prescribe regulations to allow a parent corporation to elect to treat certain sales and dispositions of stock in a subsidiary as a sale of assets, so gain would be recognized and basis would be increased. This election is relevant to divisions that fail to qualify under Section 355, or fail to qualify for nonrecognition of gain under the disqualified distribution rule (Section 355(d)) or the Morris Trust rule (Section 355(e)). This rule can prevent multiple levels of tax, when the distribution is made (because of failure to qualify for tax-exempt treatment) and if the assets are subsequently sold.

"Cash Rich" Corporations

This provision (Section 355(g)) was added in 2005 and disallowed Section 355 treatment when either the distributing or controlled corporation had more than two-thirds of the assets in investment assets, and one shareholder controls at least 50% of the value.

Real Estate Investment Trusts

A provision (Section 355(f)) was added in 2015 to disallow Section 355 treatment for distributing or controlled corporations that became real estate investment trusts (REITs). REITs are not generally taxed at the corporate level.

Corporate Reorganizations and the 15% Corporate Alternative Minimum Tax

The Inflation Reduction Act of 2022 (P.L. 117-169) imposed a corporate alternative minimum tax (CAMT) based on financial statement income.[41] The minimum tax is 15% of financial income adjusted in a number of ways, and firms pay the larger of the minimum tax or the regular tax imposed at a 21% rate.[42] It is limited to larger corporations with an average of $1 billion or more

[40] The name Morris Trust refers to a 1966 court decision, *Commissioner of Internal Revenue vs. Mary Archer W. Morris Trust*.

[41] See CRS Report R47328, *The 15% Corporate Alternative Minimum Tax*, by Jane G. Gravelle.

[42] The regular tax includes any additional tax from the Base Erosion and Anti-Abuse Tax (BEAT). BEAT is discussed in CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples.

in earnings over a three-year period. A number of adjustments to financial statement income were made in the statute, which also provided broad authority to the Secretary of the Treasury to prescribe regulations.

One issue not addressed in the statute was the treatment of corporate reorganizations. Corporate reorganizations raise two concerns: (1) the recognition of certain income in reorganizations for financial but not for tax purposes; and (2) how changes in ownership should be considered for purposes of defining firms subject to the tax.

Preliminary guidance issued in December 2022 indicated that financial statement income would be adjusted to eliminate the recognition of income or a change in basis that does not conform to the tax laws on corporate reorganizations. The treatment of boot is unresolved and will, according to the preliminary guidance, be addressed subsequently.[43]

The second issue is how mergers and divisions affect the determination of whether a corporation is subject to the CAMT, referred to as an *applicable corporation*. The general rule is that once a corporation becomes subject to the CAMT, it continues to be subject to it. There are exceptions for cases where the firm subsequently does not meet the test, as determined by the Secretary of the Treasury. In addition, there is an exception if ownership changes.

The December 2022 guidance indicates that when a firm acquires a stand-alone target that is an applicable corporation, the target is no longer an applicable corporation and the acquirer takes into account the financial statement income of the target for determining whether it is an applicable corporation under the three-year test. When a firm acquires part of another firm, the financial statement income of the target is included in both the acquirer's and the original firm's financial income for the three-year test. Similarly, in a division where a controlled corporation is distributed to the parent's shareholders, the financial statement income of the controlled corporation is included in both the parent's three-year test and the spun-off firm's. The regulations do not address methods of allocating financial statement income in mergers and divisions.[44]

The nature of the minimum tax means that mergers and divisions have additional potential tax consequences. A merger, for example, could create a larger firm that would be subject to the CAMT, while a division might cause the firm to no longer be subject to it. A merger of a firm subject to the CAMT with a firm that has a high effective tax rate will reduce any minimum tax due, since the income and taxes will be combined. For example, if two firms of equal size merge, one with a 10% effective tax rate (thus paying 5% of income as a tax) and one with a 20% effective tax rate, the overall tax rate becomes 15% and no CAMT is due. A division could generate higher minimum taxes if one portion has low tax rates and another high tax rates. For example, a firm with an effective tax rate of 15% that splits into two businesses of the same size, one with a 10% tax rate and one with a 20% tax rate, will be subject to an additional tax rate of 2.5% of the combined profits.

[43] Internal Revenue Service, Initial Guidance Regarding the Application of the Corporate Alternative Minimum Tax under Sections 55, 56A, and 59 of the Internal Revenue Code, Notice 2023-7, December 27, 2022, https://www.irs.gov/pub/irs-drop/n-23-07.pdf. For a discussion of this guidance, see DavisPolk, "IRS Issues Interim Guidance on the Corporate Alternative Minimum Tax," December 30, 2022, at https://www.davispolk.com/insights/client-update/irs-issues-interim-guidance-corporate-alternative-minimum-tax.

[44] In addition to the DavisPolk discussion, see *EY*, "US IRS Releases Interim Guidance on 15% Corporate Alternative Minimum Tax," January 13, 2023, https://globaltaxnews.ey.com/news/2023-5050-us-irs-releases-interim-guidance-on-15-percent-corporate-alternative-minimum-tax; and Holland&Kinght, "Notice 2023-7: First Peek at Corporate AMT Guidance," January 9, 2023, https://www.hklaw.com/en/insights/publications/2023/01/notice-20237-first-peak-at-corporate-amt-guidance.

The 1% Tax on Corporate Stock Repurchases

The Inflation Reduction Act (IRA) also included a 1% excise tax on stock repurchases by publicly traded corporations.[45] President Biden and several Senators have proposed to increase the rate to 4%.

The law specifically excludes tax-free corporate reorganizations outlined in Section 368(a) of the IRC, which include mergers, acquisitions, divisions, and other forms of reorganization. In tax-free reorganizations, gain is not generally recognized when compensation is in stock (e.g., shareholders of the target company in an acquisition redeem their stock for stock of the acquiring company). Gain is recognized to the extent shareholders are compensated in cash or other property (boot).

Commentators raised two issues about the effect of the tax on reorganizations. One was whether reorganizations will be completely exempt from the tax, or only stock compensation and not boot will be excluded. The other concern is certain split-offs that are governed by another section of the tax code, Section 355. Divisions can take place under either section and constitute the same type of distribution, but the IRA only refers to Section 368. Divisions can take place as spin-offs (where stock of a subsidiary is distributed pro rata to the shareholders), which does not involve a repurchase. However, divisions can take place as split-offs where the subsidiary's stock is exchanged for the parent company's stock, which may also involve payment of cash or property (boot).

Interim regulations and examples clarify that the exception for tax-free reorganizations under Section 368 excludes stock transferred in these reorganizations from the tax but not any boot that is exchanged for stock and subject to gain. For example, if part of the payment for the stock of a target is cash and part is in acquirer stock, the share that is cash will be subject to the excise tax as a repurchase by the target. It also confirms that Section 355 split-ups are subject to the exclusion as well.[46]

Implications of the OECD/G20 15% Minimum Tax (Pillar 2)

The OECD/G20 has proposed a global minimum tax of 15% that will be imposed on financial income under Pillar 2 of its two-pillar solution to internal base erosion and profit shifting.[47] A number of countries are in the process of adopting the rules, including member states of the European Union, the United Kingdom, South Korea, Japan, and Canada. The tax applies to companies with global revenues exceeding €750 billion (equivalent to about $810 billion based

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[45] P.L. 117-169, 136 Stat. 1818. For more information on the 1% excise tax, see CRS Report R47397, *The 1% Excise Tax on Stock Repurchases (Buybacks)*, by Jane G. Gravelle.

[46] Internal Revenue Service, Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code, Notice 2023-2, December 27, 2022, https://www.irs.gov/pub/irs-drop/n-23-02.pdf. For a more detailed discussion that links to sections of the notice, see Paul/Weiss, "IRS Issues Guidance on Excise Tax on Stock Repurchases and Corporate Alternative Minimum Tax," December 29, 2022, https://www.paulweiss.com/practices/transactional/tax/publications/irs-issues-guidance-on-excise-tax-on-stock-repurchases-and-corporate-alternative-minimum-tax?id=45658. See also DavisPolk, "IRS Issues Interim Guidance On the Stock Repurchase Excise Tax," December 28, 2022, https://www.davispolk.com/insights/client-update/irs-issues-interim-guidance-stock-repurchase-excise-tax.

[47] See CRS Report R47174, *The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy*, by Jane G. Gravelle and Mark P. Keightley for a general discussion.

on August 22, 2023, exchange rates) in at least two of the four fiscal years preceding the current fiscal year. The OECD/G20 global minimum tax is referred to as GLoBE.

Top-up taxes will be applied to raise the effective tax rate on financial income to 15%. The right to levy a top-up tax goes first to the country where the firm is located through a qualified domestic minimum top-up tax (QDMTT). If the country of location does not impose a top-up tax on income earned in the country, the home country of the parent company can collect the tax through the income inclusion rule (IIR) by increasing the income of the parent subject to tax. If neither of these taxes apply, then countries where other constituent entities (such as subsidiaries and branches) are located can collect the tax by denying deductions for those constituent entities through the undertaxed payments rule (UTPR). This latter rule is often referred to as the undertaxed profits rule.

In general, a reorganization under the GLoBE rules will not result in immediate taxation of gain if the reorganization is a GLoBE reorganization.[48] A GLoBE reorganization is one where all or a significant portion of consideration for the transfer is in stock and where the gain is not taxed. Thus, GLoBE will generally allow tax-free reorganizations in the same way as under the U.S. corporate tax.

The OECD guidelines indicate that for application of the threshold and the four-year test, financial income of entities that merge will be combined for prior years to determine applicability. For divisions, the threshold is based on the financial income for each entity. For the first year after the division, the threshold will be based on the current revenues. For the second through the fourth years, it will be based on any two years that meet the threshold.

As with the CAMT, GLoBE will lead to additional tax consequences for mergers and divisions. It is currently unclear whether or when the United States will enact rules complying with GLoBE, but even if the United States takes no action, its firms can be taxed under other countries' IIRs or UTPRs. GLoBE will likely be more far reaching than the CAMT because of the lower threshold. While many mergers will be tax exempt or partially tax exempt, reorganizations may cause firms to be subject to GLoBE through a merger, or no longer subject to the tax through a division. Also, as is the case with the CAMT, a merger by an affected firm with a target that has a high effective tax rate can reduce the amount of GLoBE tax paid, while a division can increase it.

GLoBE might also favor acquisition of companies by private equity firms rather than other firms because GLoBE does not count income and taxes paid by portfolio companies as part of consolidated income for determining the effective tax rate.

Another new issue raised by GLoBE is the treatment of deferred taxes. For example, accelerated depreciation may lead to large current depreciation deductions that will reduce the effective tax rate currently but raise it in the future. The GLoBE rules allow taxes to be increased in the current year to account for the timing with the increase recovered over time (lowering the effective tax rate). This attribute is another one that may affect mergers or divisions given an expected decline in the effective tax rate in the future when merging with a firm that has deferred tax liabilities.

[48] Reorganizations are discussed in the OCED's December 2021 guidance, *Tax Challenges Arising from the Digitalisation of the Economy, Global Anti-Base Erosion Model Rules (Pillar Two)*, Sections 6.1-6.2 and Section 10.1, available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

There is a similar type of treatment of deferred tax assets (savings that are expected in the future).[49]

Some issues are not clear yet. For example, there is no indication that companies can choose a 338(g) election to treat an asset purchase as a stock purchase.

Potential Reforms

Concerns with mergers and acquisitions differ from those for divisive reorganizations (although the two may be part of a single reorganization where part of a company is spun off before merging with another company).

Mergers and Acquisitions

Tax-free mergers can be viewed as removing a barrier to mergers or as departing from the general rule that gains are recognized when they are realized. The general justification for tax-favored treatment under tax principles is that the business is continued by the same shareholders. Nevertheless, stock received by shareholders in an exchange reflects a different investment from the previous shares. This effect is especially pronounced for shareholders of a small company acquired by a large company.

Aside from tax principles, perhaps the more important issue is the effect of mergers on market power and anticompetitive behavior. The mechanism currently used to address this issue is antitrust laws. At least some view these laws and their execution as too narrow.[50] Eliminating or reducing the tax benefits for mergers can be beneficial for society if mergers primarily lead to market power rather than efficiency gains. Tax-free mergers could be denied altogether or a higher share of stock compensation could be required to qualify for tax-free treatment.

Another consideration for tax policy is tax provisions that lead to mergers that would otherwise not occur. Traditionally, this issue has focused on acquiring firms with net operating losses, which is why the use of the losses is restricted to a measure of profit rate to the assets of the target. However, the combined firm can gain a benefit if the gain from an asset acquisition is offset by net operating losses, and the basis is increased to market value, increasing depreciation deductions and reducing future capital gain.

As noted earlier, in recent years, policymakers have given special attention to inversions, where a U.S. firm shifts its headquarters abroad in order to benefit from lower tax rates in foreign jurisdictions and facilitate profit shifting. H.R. 884 (Doggett) and S. 357 (Whitehouse) would treat firms where the former U.S. shareholders control more than 50% of the firm as U.S. corporations. This treatment does not directly address the tax-free reorganization rules but does further reduce the tax incentive for international mergers.

Special issues also arise with the use of debt financing for asset acquisitions, since the assets of the target can also be used as security for the loan. Provisions in the tax code (Section 279) limit the deductions for highly leveraged acquisitions.

[49] See further discussion in Freshfields Bruckhaus Deringer, *The Impact of the OECD's Pillar Two on International M&A*, July 11, 2022, https://www.freshfields.us/4a2d0a/globalassets/noindex/articles/the-impact-of-the-oecds-pillar-two-on-international-manda.pdf.

[50] See Bill Bauer, "Improving Antitrust Law in America," Brookings Institution, October 1, 2020, https://www.brookings.edu/articles/improving-antitrust-law-in-america/.

Divisions

Divisions do not raise the market concentration issues associated with acquisitions, and an argument can be made that they are beneficial, leading to more efficient production. Most of the concern with tax-free divisions is whether they are being used for their purpose, which is to continue the historical business with historical shareholders, and whether they are being used to distribute earnings in tax-preferred fashion. This section surveys some potential reforms to tighten requirements for tax-free divisions that have been proposed in legislation and in law review articles. While some of these reforms are suggested as regulations, they could also be enacted into law.

Transactions with Debt

In the earlier versions of H.R. 5376 in the 117th Congress, which passed the House as the Build Back Better Act, a provision would have tightened the rules regarding recognition of gain to the parent (distributing) corporation. Under current law, the distributing corporation recognizes gain on the amount of distributing corporation debt assumed by the subsidiary in excess of the basis of property transferred and on boot in excess of basis reduced by debt assumed. The distributing corporation can receive tax free any newly issued securities of the subsidiary and use them to pay the distributing company creditors. This provision would reduce the basis by any securities of the controlled corporation received, so that gain will be recognized to the extent the sum of boot, assumed liabilities, and controlled corporation securities exceeds the basis of assets transferred. This change would result in equal treatment of all forms of receipt other than the controlled corporation's stock, but would make it more difficult to reallocate debt between the parent and subsidiary.[51]

In a law review article, Schler proposes that distribution of stock to creditors would be taxable to the parent.[52] Boot in excess of basis less assumed liabilities would be taxable to the parent if distributed to creditors.

Both these proposals would increase the firm-level tax in certain transactions involving debt.

Business Purpose

Whether a division meets a business purpose can be unclear. Schler proposes two alternatives to simplify dealing with the business purpose test, one to tighten the business purpose test so that there has to be a fundamental and objective purpose, such as avoiding regulatory problems with an acquisition or when competitors of a parent do not want to deal with a subsidiary when related to the parent.[53] It would eliminate reasons such as different shareholders wanting to focus on different businesses. He notes that this could be justified in light of *General Utilities* repeal, but also states that it is not clear such a proposal would be consistent with congressional intent. A second alternative would be to expand it to include enhancing shareholder value, the same as in other reorganizations other than to facilitate shareholder sales. Either alternative would simplify the test, but the first alternative would be more restrictive. Schler prefers the second alternative, in

[51] For a more detailed discussion, see Thomas Wood and William Alexander, "Build Back Better Act Would Change Monetization Playbook for Tax-Free Spin-Offs," Skadden Arps Slate, Meagher and Flom, LLP, December 17, 2021, https://www.skadden.com/insights/publications/2021/12/build-back-better-act-would-change-monetization-playbook.

[52] Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr.

[53] Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr.

part because he thinks the first may be too restrictive. It might be difficult to put this change into legislative language to codify the rule.

Continuity of Interest

Wells argues that the various responses to limiting the ability of Section 355 divisions to circumvent *General Utilities* involve inconsistent standards across provisions regarding continuity of interest and are applied under the regulations with subjective factors considered. He suggests a bright-line objective test that includes a five-year testing period before the distribution and a two-year testing period after it. He suggests use of the rules in Section 382, which limit the carryover of certain tax attributes (such as net operating losses and unused credits) when an ownership change has occurred. Under this provision, ownership change occurs when 5% of shareholders together gain more than 50% of the corporation through acquisition in the testing period. His basic view is that Section 355 should not allow nonrecognition to divisions that allow assets to be transferred to a new shareholder group, and that the present rules do not achieve that purpose.

Yin suggests that Treasury regulations have undermined much of the intent of Section 355 and suggests providing a fixed period of time during which a significant change in ownership would disallow tax-free treatment, which cannot be rebutted.[54] He also indicates that a change in ownership should not reflect changes as the result of the division itself or portfolio trading (selling stock by shareholders who own less than a small percentage of the shares), but that liquidation of a corporate component of the division should count as an asset change.

Beller suggests a general section that would disallow tax-free treatment (of both the corporation and the shareholders) if control changed by 50% or more in a period before and after the spin-off (e.g., two years before and two years after). This rule could replace Sections 355(d) (disqualified distributions) and 355(e) (Morris Trust Rules). This treatment also might be limited to disallowing tax-free treatment at the corporate level, as is the current case for these sections. (Note, however, that current Section 355(d) has a more restrictive rule for five years before the distribution. Thus, it is not clear that this provision is more restrictive.)

Control

Both Schler and Beller would replace the current control test with a requirement of 80% of stock by vote *and* value.[55]

Treatment of Distributions

Wells would treat as a dividend a distribution when the other corporation is excessively leveraged, which he suggests would occur when the other corporation has a debt-to-equity ratio that is 120% of the average ratio before the division.[56] This leveraging change pushes more of the assets into the corporation whose stock is being distributed.

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[54] George K. Yin, "Taxing Corporate Divisions," *SMU Law Review*, vol. 56, no. 1 (2003), Article 10, https://scholar.smu.edu/smulr/vol56/iss1/10/.

[55] Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr; and Herbert M. Beller, "Section 355 Revisited: Time for a Major Overhaul?" 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232960.

[56] Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr.

Active Business Requirement and the Device Test

A common theme in proposals (outside of the provision in the Build Back Better Act) is the limited requirement for the share of active business assets in total assets. There is currently no limit, although some standards are in the proposed 2016 regulations. Wells suggests requiring both the distributing and controlled corporation to have more than 50% of assets in historically active business assets.[57] He argues that the purpose of Section 355 is to separate a historical business between historical shareholders, and without this standard the division only serves to distribute assets out of corporate solution. While he proposes this standard as part of the regulations, it could be enacted in statute.

Beller has a similar active business test proposal to require 50% of assets in historical assets.[58] He also suggests that consideration should be given to treating as boot a distribution of subsidiary stock attributable to nonbusiness assets. If a 50% test is adopted, Section 355(g) would need to be amended to conform, by reducing the two-thirds of assets rule. If the 50% active business asset rule applies, and either the distributing firm or subsidiary has a certain amount (e.g., 25%) of assets in nonbusiness assets, this amount would be evidence of a device. He also proposes that both the distributing and controlled corporations should be required to continue in the same business for two years, unless the taxpayer can demonstrate the change was not part of the divisive reorganization plan.

Schler also suggests a higher active business percentage of 50%, but would set it as a requirement for the combined entities.[59] He also suggests that business assets acquired under the business expansion rule within five years should be treated as evidence of a device under the device restriction rule. Distributions by the parent would be taxable if assets satisfying the active 50% business requirement acquired within the past five years were some (to be determined, perhaps 20% or 25%) share of the total and the facts and circumstances indicate that tax-free treatment would be inconsistent with *General Utilities* repeal or the 50% business test.

Schler has a number of proposed revisions to the device test, although he argues that the device test should be retained. One of the features indicating evidence of a device is the existence of a secondary business that serves other businesses and could be sold without affecting the main businesses. Schler argues that this feature should be eliminated, as it is no different from other business components. He also indicates that a rule that a public corporation should show that there is no intention of 5% of shareholders to sell as evidence against a device could be revised. He indicates that shareholders without management influence, such as mutual funds, should not be included in this test. Schler also argues that assets acquired within the five-year testing period in the same trade or business, which are currently treated as five-year assets under the expansion of business doctrine, should be excluded from the five-year test.

[57] Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr.

[58] Herbert M. Beller, "Section 355 Revisited: Time for a Major Overhaul?" 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232960.

[59] Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr.

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