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### The Positive Role of Tax Law in Corporate and Capital Markets

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# ESSAY

## The Positive Role of Tax Law In Corporate and Capital Markets

Saul Levmore\*

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### I. INTRUSIONS OF TAX LAW INTO CORPORATE LAW

Taxes normally and correctly are considered to be unfortunate and annoying intruders in the elegant world of capital markets and in the already complicated world of corporate law. There are no fewer than eleven different types of intrusions which may be recognized easily. First, because tax law focuses on “recognition” events rather than periodic appraisals of wealth and does not excuse or defer tax on gains from the sale of stock and other capital assets completely, exchanges are discouraged.<sup>1</sup> Similar to brokers’ commissions, taxes add to transaction costs and, therefore, discourage transactions.<sup>2</sup> Second, by taxing dividends more harshly than income realized from the sale of stock, and by taxing such dividends less harshly when they are of the intercorporate variety, tax law may affect the dividend policy of a firm.<sup>3</sup> To the extent that a firm’s

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1. The intrusion, of course, is not limited to capital assets. For example, inventories might be accumulated and disposed of differently in the face of taxes which are triggered by various transactions. I have, however, slanted the generalizations in the text toward matters most relevant to contests for corporate control and other topics of current interest.

2. To the extent that transactions are entered into voluntarily and are the means by which assets move to their highest valued uses, taxes can be said to cause a reduction in welfare. The question often is how to raise revenue for projects that may improve welfare in a manner that is least harmful. See generally Feldstein, *Personal Taxation and Portfolio Composition: An Econometric Analysis*, 44 *ECONOMETRICA* 631 (1976); Feldstein, Slemrod & Yitzhaki, *The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains*, 94 Q.J. *ECON.* 777 (1980); Sprinkel & West, *Effects of Capital Gains Taxes on Investment Decisions*, 35 *J. Bus.* 122 (1962).

3. Tax law, thus, causes corporate and individual shareholders to have different attitudes toward the distribution of dividends. Note that the elimination of the preference for capital gains

dividend policy is affected, its overall reinvestment policy probably will be affected.<sup>4</sup> Third, the compensation packages offered to managers and other agents of the firm likely will be influenced by tax laws. Recipients may prefer deferred compensation, certain fringe benefits, and particular types of profit-sharing plans. These preferences may make it worthwhile for employers to structure compensation differently than how they would have if taxes did not depend on the form of compensation. Stated in terms of the literature on agency costs, a certain compensation package offered to agents may minimize the monitoring costs of the shareholders and creditors of a firm, but tax law may encourage the use of a different package that causes higher agency costs even though such a package may include stock options which on their own may decrease agency costs.<sup>5</sup> Fourth, although in the absence of taxes there may be an optimal means of financing the firm, tax laws will make some capital structures appear more attractive than others. For example, tax laws that allow deductions for interest expenses but not dividend payments encourage debt financing.<sup>6</sup> Fifth, the treatment of financial intermediaries, such as banks and stock and mutual insurance companies, is sufficiently uneven to suggest that the existing mix of these intermediaries is influenced more strongly by tax considerations than by organizational qualities.<sup>7</sup> Sixth, because inputs such as labor and property often are taxed separately and differently, the mix of inputs that is utilized in a given enterprise is different from that which is most efficient in terms of real productivity.<sup>8</sup> Seventh, inputs aside, the very size of an enterprise probably will be influenced by taxes. The tax system encourages the retention of earnings, and therefore growth,<sup>9</sup> and it allows multidivision enterprises to offset the gains and losses of different divisions while smaller single-division firms are unable to

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in the Tax Reform Act of 1986 does not make shareholders indifferent between dividends and stock sales. When selling stock, shareholders are given immediate credit for the cost or basis of their stock.

4. For example, if the firm can earn 10% on its next available project, and shareholders can earn 11% on their own, reinvestment rather than distribution, nevertheless, may occur because of the tax cost of the distribution. Shareholders may be able to invest at 11% with funds they will borrow on the strength of their shareholdings, which, in turn, are affected positively by the firm's retention of earnings. In general, tax laws probably encourage larger businesses. See A. FELD, *TAX POLICY AND CORPORATE CONCENTRATION* 55-100 (1982) (treatment of retained earnings and reorganizations encourages big businesses).

5. For the seminal presentation of the agency cost insight *without* taxes, see Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

6. The question is debated frequently. Compare Miller, *Debt and Taxes*, 32 J. FIN. 261 (1977) and Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) with Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575 (1984); see also Ross, *Debt and Taxes and Uncertainty*, 40 J. FIN. 637 (1985). For a discussion of the possibility that reactions are bifurcated, see Auerbach & King, *Taxation, Portfolio Choice, and Debt-Equity Ratios: A General Equilibrium Model*, 98 Q.J. ECON. 587 (1983).

7. See LIFE INSURANCE COMPANY TAXATION: THE MUTUAL VS. STOCK DIFFERENTIAL (M. Graetz ed. 1986); Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603 (1975).

8. Of course, there is a significant amount of literature on the assessment and collection of property taxes. Unfortunately, less work has been done on employment-related taxes. See Kelly, *Taxes, Depreciation, and Capital Waste*, 24 NAT'L TAX J. 31 (1971).

9. See Campisano & Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U.L. REV. 709 (1981). Note also that because losses suffered by one enterprise sometimes can be applied against gains of another or gains at a different time, a conglomerate normally can offset gains against losses in this manner as a matter of course. *Id.* at 721-22. The treatment of losses, thus, is "intrusive" and encourages large firms, even though such enterprises may be suboptimal from the standpoint of agency costs or other "real" concerns.

transfer the full tax value of their losses to profitable enterprises.<sup>10</sup> Eighth, similarly, the treatment of business losses and the progressive character of tax rates may discourage risky investments even when the expected values of such investments exceed those of investments with less variance in possible outcomes.<sup>11</sup> Ninth, tax laws may encourage a mix of ownership forms different from that which would prevail as a result of agency cost and other real or non-tax considerations. Examples of such rules are those that encourage or discourage leasing, and those that deny certain treatments when there are more than some specified number of shareholders.<sup>12</sup> Indeed, an ownership change as important as a leveraged buyout may be motivated largely by tax considerations. The significant premiums enjoyed by those who sell their interests to insiders in these buyouts may reflect little more than their proportionate shares of the tax savings.<sup>13</sup> Tenth, and most simply, capital may be deployed in various geographic locations in spite of inferior resources, labor, or transportation, because relatively low taxes are associated with these locations. Last, tax laws intrude upon the allocation of resources among industries. The various exclusions, depreciation schedules, and accounting rules which are the soft underbelly of the tax system yield different marginal and average tax rates—and, therefore, different incentives to invest—in different types of enterprises.<sup>14</sup> To the extent that such differentials reflect accidental political arrangements rather than sensible social policies regarding externalities and public goods, resources surely are misallocated. Unfortunately, the tax system itself makes it difficult to assess these differentials, because it imposes taxes not only on the firm, but also on the receipts of shareholders and bondholders. Inasmuch as these payments to investors *themselves* may play roles in the efficient allocation of resources, a comparison of all the taxes associated with various enterprises and industries is necessary before concluding that apparent differentials inefficiently bias investment.

The length and relentless quality of this list suggests that intrusions under the tax laws are tolerated, at least partially. This tolerance is the product of a political and an economic reality. As a political matter, those who draft and enforce tax laws are most concerned with the ability and ingenuity of taxpayers to avoid taxes. From this perspective, the efficiency cost of a tax actually may be welcome because the cost usually forms a constraint on tax avoidance. For example, because there are organizational or efficiency reasons to offer employees certain compensation packages, employers will not use those packages that

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10. See Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (Supp. 1956); see also Brennan, *Taxes, Market Valuation and Corporate Financial Policy*, 25 NAT'L TAX J. 417 (1970).

11. See generally Campisano & Romano, *supra* note 9, at 722-30; Fellingham & Wolfson, *Taxes and Risk Sharing*, 60 ACCT. REV. 10 (1985).

12. For a discussion of leasing, see R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 547-61 (2d ed. 1984). For a discussion of the choice among the partnership, corporate, and "S" Corporation entity forms, see Thompson, *The Federal Income Tax Impact of the Operating Function on the Choice of Business Form: Partnership, Subchapter C Corporation, or Subchapter S Corporation*, 4 BLACK L.J. 11 (1974); Wolfe & DeJong, *The S Corporation as an Alternative Form of Business Organization After ERTA, TEFRA and the Subchapter S Revision Act of 1982*, 32 DE PAUL L. REV. 811 (1983).

13. Prior to the Tax Reform Act of 1986, the basis of a firm's assets could be "stepped-up" —an occurrence that was advantageous for depreciation purposes— at the cost of one capital gains tax assessment. The general point was not lost on legislators. See H.R. REP. NO. 426, 99th Cong., 1st Sess. 281-82 (1985) (tax benefits induce liquidations and asset transfers).

14. See Hulten & Robertson, *The Taxation of High Technology Industries*, 37 NAT'L TAX J. 327 (1984).

minimize taxes. Similarly, because there are real efficiencies gained by conducting business in given forms, sizes, and locations, taxpayers often will fail to take advantage of all avoidance strategies, including transformations of form and relocations, because there are real costs to such strategies. A less ambitious way to state this point is as follows: Lawmakers are wary of taxpayers avoiding all forms of taxation and, therefore, when a tax appears to distort economic behavior on the margin, these lawmakers might focus less on the inefficiencies generated by the particular tax than on the inframargin where taxpayers are locked in sufficiently and unable to escape the tax.

The economic explanation of why so many intrusions of tax law in the functioning of capital and other markets are tolerated begins with the observation that every major tax in our collective arsenal is intrusive. For example, property taxes distort the use of inputs, and income taxes reduce the incentive to earn more income. Given the government's need to raise substantial amounts of money, every method of raising revenues may be intrusive in some market, and these intrusions progressively become more serious as additional revenue is sought through increases in any one method of taxation. Therefore, intrusions of the kind discussed above may be tolerated because alternatives are thought to entail other or more serious inefficiencies.

This last explanation becomes less abstract if a familiar contemporary example is reviewed. A tax on the sale or exchange of capital assets, or any assets for that matter, is intrusive in the sense that taxpayers may retain such assets longer than they would have if the exchanges would not trigger taxation. Therefore, efficiency might be enhanced if this tax were repealed, or if appreciation were taxed periodically, regardless of whether an exchange had taken place. Assuming away the latter possibility for either political or administrative reasons, and assuming an unrelenting demand for the revenues currently raised from the taxation of capital gains, eliminating the taxation of gain on the sale of stock or real estate would require an increase in the tax rates applicable to other less favored income. In turn, these higher rates would discourage work, as opposed to leisure, and encourage efforts to avoid taxes or to engage in tax-favored, but unproductive activities. This familiar illustration, and the more general arguments or explanations of why so many intrusions by the tax laws are tolerated, emphasizes the premise of this Essay: Our tax system contains numerous moderate intrusions *but* to expect that the system could be otherwise is unrealistic.

In spite of the preceding sketches and arguments regarding the seemingly endless set of intrusions by tax law into corporate and capital markets, the goal of this Essay is to arrive at an opposite conclusion that does not depend upon an agreement about the magnitudes of various intrusions. Rather, the aim is to show that there are ways in which tax law compliments or supports, rather than intrudes upon, the efficient functioning of corporate and capital markets. These illustrations are meant to be revealing and interesting on their own, while also suggesting that there are important interactions between tax law, agency cost, and other efficiency considerations. Although one may be able to study some industries and markets without considering the effect of the tax laws, to separate an understanding of the market for corporate control, for example, from an understanding of the taxes levied upon assets and transactions in that market, is not possible.

In exploring the "positive interactions" of tax law and corporate law, this author does not mean to imply that the various intrusions are somehow less im-

portant than the positive interactions. For some time these intrusions have been the focus of the tax policy literature, and for good reason. On the other hand, some of the interactions between tax law and corporate law are quite subtle, and exploration of these interactions requires considerable familiarity with, and sensitivity to, the world of corporate law, rather than the world of public finance, which is the normal background for academics who write about tax policy.

Stated somewhat differently, although the central argument of this Essay, that there are subtle, positive roles played by taxes which should be considered seriously, the Essay has other broader aims. Tax law, especially corporate tax law, too often is seen as something to be ignored or left to the specialists who examine legislative histories and drive trucks through seemingly small loopholes. This Essay seeks to tempt those who think about the corporate and capital markets to study and think about tax law because these subjects regularly overlap. There are two specific areas of interaction explored in this Essay. First, the ways in which tax law influences the mix of debt and equity used in financing the corporate firm. Second, the way in which certain kinds of stock acquisitions are treated and influenced by tax legislation. The detail and complexity of these examples suggest that tax law, at least in part, must become the province of those who think carefully about corporate law.

## II. THE POSITIVE INFLUENCE OF TAX LAW ON THE CAPITAL STRUCTURE OF FIRMS

As noted above, taxes may interfere with the central message of the Modigliani-Miller irrelevance proposition.<sup>15</sup> This intrusion certainly will result if a significant number of tax-exempt or low-taxed investors such as pension funds, businesses that lend money to pension funds, and charitable foundations, can invest in corporate debt. Inasmuch as interest payments on such debt are deductible to the issuing corporation, while dividend payments are not, high debt-equity ratios may result from such intrusions.<sup>16</sup> The existence of these abnormal investors or creditors is an important part of the story, because without their presence the deductibility of interest payments by firms with high debt-equity ratios would be no more advantageous than is the deductibility of interest payments by individuals who, in accordance with the classic story of homemade leverage, borrow money in order to buy stock in firms with low debt-equity ratios. However, when there are many tax-exempt investors, and when it is easier, for institutional and legal reasons, for those investors to lend to firms rather than to many dispersed individuals, there will be a significant amount of debt at the firm level rather than at the individual level, because firms obviously will find it less expensive to borrow, from eager, tax-exempt lenders, than will individuals.

If everything else about capital structure were irrelevant, none of this activity would be troubling. Firms simply would have high debt-equity ratios but as a normative matter no combination of debt and equity would be better or worse than another. An argument against excessive debt, for instance, must incorporate an assumption or rely upon a set of facts that is contrary to the assumptions of the irrelevance proposition. Thus, one could assert that bankruptcy generates great private and social costs while also arguing that large amounts of debt are undesirable because the probability of bankruptcy, and unanticipated displace-

15. See generally Modigliani & Miller, *supra* note 6.

16. See Canellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91, 100-01 (1985).

ments increases. In turn, one could argue that debt can and should be discouraged, either by requiring tax-exempt institutions to pay tax on the receipt of interest income, or by denying interest deductions to issuers, to the extent that creditors do not pay tax on their receipts of interest payments.<sup>17</sup> I prefer, however, to construct this argument around agency costs instead of bankruptcy costs, because the expected value of the latter may be small.<sup>18</sup> Arguably there is an optimal capital structure for each firm because some combinations of secured debt, unsecured debt, and equity—and even preferred stock and convertible securities—generate lower agency costs than other combinations. There is little point in reviewing the literature regarding these matters; suffice it to say that for a given firm, some capital structures may reduce monitoring and bondings costs better than others—perhaps by encouraging some creditors to monitor the firm and by giving a firm's managers a great incentive to maximize profits without encouraging so much risk-taking that the cost of borrowed capital becomes excessively great<sup>19</sup>—and that tax laws may intrude inefficiently on financing decisions as discussed earlier.<sup>20</sup> Again, the solution may be to require the issuer to withhold taxes unless the recipient pays tax on interest payments.

With this “negative” effect which taxes exert upon financial policy in mind, consider now the following set of tax laws that may have a “positive” effect. Section 351 of the Internal Revenue Code<sup>21</sup> allows parties who pool capital and form a corporation to receive stock and securities, including bonds (that are not very short in term), in return for the property that they contribute, without recognizing gain on the transaction. If, for instance, A, B, and C contribute cash, appreciated real estate, and appreciated stock of some other company (X), to a corporation in return for its stock and bonds, neither the corporation nor A, B, or C will recognize any gain; all tax is deferred. C, for example, will take the basis that he had in his appreciated shares of the X Corporation as the basis for the stock and securities that he receives. Note, however, that section 351 does not apply to a situation in which an *ongoing* firm distributes bonds to its shareholders. To the extent that these bonds are received in a non pro rata fashion, the difference between the value of the bonds and the basis of the assets exchanged will be taxed as gain from an exchange. If the bonds are distributed in a pro rata fashion, they will be treated under section 301 as dividends.<sup>22</sup> The tax treatment of such bonds often is explained as differing from that of stock dividends, which can be received from an ongoing corporation in pro rata fashion without triggering a tax, because a given corporation's bonds are more liquid than its stock. Thus, bonds, like cash, are taxed upon receipt. This explanation merely highlights the remarkable difference between the treat-

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17. Issuers could be required to withhold taxes unless payees demonstrated or affirmed that they pay taxes.

18. Of course, not everyone agrees that the expected value of bankruptcy is low. Compare Gordon & Malkiel, *Corporation Finance*, in HOW TAXES AFFECT ECONOMIC BEHAVIOR (1981) and R. Brealey & S. Meyers, *supra* note 12, at 390-401 with Haugen & Senbet, *The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure*, 33 J. FIN. 383 (1978).

19. See generally Jensen & Meckling, *supra* note 5; Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982).

20. See *supra* text accompanying note 6.

21. I.R.C. § 351 (1982).

22. *Id.* §§ 301, 351. The uninitiated reader might consult B. BITTKER & J. EUSTICE, *FUNDAMENTALS OF FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1980).

ment of different bond distributions. Section 351 governs if the bonds are distributed at the time of formation<sup>23</sup> while section 301 provides the rule when bonds are distributed by an ongoing firm. The difference is extreme: bonds are favored at formation, but are as disfavored as cash afterwards.<sup>24</sup>

In Modigliani-Miller terms ("irrelevance" or "invariance") these rules seem senseless.<sup>25</sup> Given that shareholders can borrow on their own, purchase stock in the firm, and thus create whatever risk-and-return combination they desire, the tax laws' penalization of leveraging by the ongoing firm is odd and intrusive. Individuals do *not* recognize gain when they borrow on their own, indeed they do not even recognize gain when they borrow on the strength of assets that have appreciated in their hands without being taxed.<sup>26</sup> Stated differently, assuming that an individual's role in controlling a firm is not at issue, or is not affected significantly by the firm's capital structure, when the individual contemplates joining a group that is forming a new corporation he is not likely to care about the capital structure of the new corporation. If the corporation's organizers choose a high debt-equity ratio which appears to be too risky for the investor's portfolio and taxes, the investor can buy fewer shares and become a creditor. If the opposite is true, the investor can borrow and buy more shares. Assuming either that the individual and corporate tax rates are roughly equal, and that both the investor and the firm can use their interest deductions to the fullest extent<sup>27</sup> or that the market price of the debt reflects any tax advantages and handicaps,<sup>28</sup> the initial capital structure is irrelevant to each investor. At the corporate level, section 351 simply mirrors the treatment of borrowing at the homemade or individual level. Just as an investor can use appreciated property as collateral and borrow money without recognizing any gain, so too he can contribute such assets to a corporation and let the corporation issue debt without any gain recognition.

By way of comparison, a shareowner of an ongoing firm also can manipulate

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23. Shareholders who contribute property in midstream to an ongoing corporation also may be able to receive nonrecognition treatment under § 351. However, satisfying the control requirement of § 351 may be more difficult. Inasmuch as this possibility at first may seem to contradict the argument developed in the next few pages, note that any ability to alter cheaply the capital structure, of debt-equity balance, of the firm is constrained by the value of the property transferred.

24. Note that if recognition *is* desired by the taxpayer, the corporation can be started without bonds, and it can borrow against the new collateral after incorporation. Section 351, thus, is quite friendly because it is, for the most part, elective.

25. A reader unfamiliar with the elegance and reach of the invariance notion should see R. BREALEY & S. MYERS, *supra* note 12, at 377-83; W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE* 272-95 (2d ed. 1980).

26. See M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 234-45 (4th ed. 1985) (showing how rules seem to include initial borrowing in basis and exclude subsequent borrowing from basis, but how a taxpayer can include both if he so desires). Note that if one views all this as a problem, because taxpayers can use appreciated assets as a means of borrowing for immediate consumption purposes and yet defer recognition, it will not do to tax borrowing only when specific assets are used as collateral. Such a rule would discourage secured transactions that may have an important economic purpose in the form of reducing agency costs. This solution would, instead, require that all borrowing be taxed and, therefore, a different set of problems would be created.

27. That is, that all the parties have sufficient outside income to make interest deductions useful. One also might add an assumption that any rules discounting "passive income" should be unconstraining, even though such rules might strengthen the argument that follows. It is also helpful to ignore any problems arising from an Internal Revenue Service recharacterization of debt as equity.

28. See Miller, *supra* note 6, at 267.



his risk-and-return at any time by lending or borrowing on his own. However, in this situation the shareowner is *not* indifferent to the firm's maneuvers. If the ongoing firm distributes bonds, the shareholder will have income to report because section 301, and not 351, governs the transaction; if the firm is passive and the shareholder borrows in order to buy more shares—and, thus, fashions the risk-and-return package that would have been formed by the firm's issuing bonds—there is no tax liability.

At first, this difference may seem to be indicative of yet another intrusion of tax law into the smooth functioning of corporate and capital markets. However, a more pragmatic perspective yields just the opposite conclusion. The practical message of the irrelevance proposition for corporate managers, after all, is that time and energy are best spent on real rather than financial variables; managers should try to lower real production costs and increase outputs because effort spent on determining and achieving the "optimal capital structure" is wasted. Arguably, the distinction between sections 301 and 351 *reinforces* this message because by taxing the distribution of bonds the tax law discourages managers from fiddling with the capital structure of an ongoing corporation. Thus, the law can be described as adopting a Modigliani-Miller perspective and encouraging managers to focus on real, rather than financial, variables.

The positive effect of tax law in this setting can be stated even more strongly. One can view the Code as recognizing that excessive debt (compared to agency cost considerations alone) will be encouraged by the combined presence of tax-exempt investors and the interest expense deduction. The task, in support of efficient corporate and capital markets (in agency cost, or real terms), is to discourage debt, and the rules governing midstream distributions of debt, whether in redemption, reorganization, or dividend distribution, accomplish just that by refusing nonrecognition treatment.<sup>29</sup> The tax laws governing exchanges involving debt, thus, can be deemed to discourage both excessive debt financing and irrelevant or even destructive "financial fiddling" by managers with the capital structure of the ongoing corporation.

The obvious objection to this proposition is as follows: Financial fiddling and excessive debt also should be discouraged at the time that a corporation is formed and bonds should be regarded as the equivalent of cash even at the time of incorporation. There are three lines of response to this objection. First, debt is an important factor in pooling arrangements because someone who contributes more capital than his co-venturers may conveniently be given debt. This debt financing serves two important objectives: it gives maximum incentive in the form of equity shares to other parties and it eliminates the financier's fear that his coventurers will act to dissolve the firm and capture his contribution.<sup>30</sup> Debt, is therefore more important at the time of a firm's formation than

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29. The debt-equity ratio *can* be altered at no tax cost by contribution of unappreciated property in return for bonds or by corporate-level borrowing from banks or other lenders. The argument in the text points out that these devices are difficult to block without other instructions. The point is not that all debt-equity manipulations are discouraged, but rather that tax law strikes at those that can be discouraged easily.

30. The financier will not want his coventurers to be prepaid for their services in any way that allows them to take advantage of this compensation before contributing all the effort that is expected of them. The point is illustrated and developed in Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).

at a later time. Second, the irrelevance proposition suggests that there may be an optimal capital structure that exists at the time of a firm's formation. Some firms may wish to appeal to low tax bracket investors by instituting a financing structure with a high debt-equity ratio. Others may raise capital most inexpensively by appealing to high tax bracket investors who prefer retained earnings (deferred gains) to current distributions.<sup>31</sup> Indeed, many investors would prefer a firm to announce or display its capital structure initially and *not change* this structure. Investors would be able to choose investments according to their individual tax and portfolio circumstances, and engage in homemade leverage or unleverage if they wish to adjust the risk-and-return qualities of their investments. However, investors must continue to readjust investments if the firms that they have invested in alter their capital structures. Again, the taxation of debt which is distributed to shareholders discourages such alterations, at least in the sense that the resulting tax disadvantage is so obvious that an explanation of the distribution of debt, as a strategy that is in every investor's best interest, will be difficult.<sup>32</sup> Finally, one should combine this last point with an agency cost analysis. Fiddling with the capital structure of an ongoing firm may reduce agency costs, but such fiddling may upset expectations about risk-and-return and tax considerations more than it improves agency arrangements, despite the fact that these arrangements optimally would change over time.

In short, the relatively harsh treatment surrounding the receipt of debt from ongoing corporations can be explained as partially offsetting the tendency to finance with excessive debt and as discouraging financial fiddling in the face of both the irrelevance proposition and settled investor expectations. In contrast, the relatively friendly treatment surrounding the receipt of debt by those involved in the formation of corporations can be viewed as a treatment that is in harmony both with the notion that some amount of debt is optimal for agency cost reasons and with the need for debt in pooling arrangements among coventurers who will supply different proportions of capital and labor.

The treatment of preferred stock supports the idea that there is a positive link between the law and Modigliani-Miller's irrelevance proposition. Section 351 protects the issue of preferred stock just as it protects bonds. Sections 305 and 306,<sup>33</sup> however, provide rules for the distribution of preferred stock by an ongoing corporation that are more generous than the rules available for the distribution of bonds. Similar to pure stock dividends, preferred stock can be received, even in pro rata fashion, without the recognition of gain. Taxes are assessed only when such stock is sold. The rules in this area are a bit complicated because these taxes attempt to compensate for the earlier tax-free receipt of

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31. See A. AUERBACH, *THE TAXATION OF CORPORATE INCOME* 87-90 (1983) (argument that wealth maximization is not accomplished by maximizing the firm's market value); King, *Taxation and the Cost of Capital*, 41 *REV. ECON. STUD.* 21, 25-29 (1974); R. BREALEY & S. MYERS, *supra* note 12, at 385.

32. If one believes in signalling explanations of the mystery of dividend distribution, then it may be tempting to argue that midstream debt distributions come at a high tax cost, but may be worthwhile as signals of the successful firm. These signals seem too expensive for this function. Moreover, one does not observe as many successful firms distributing debt to shareholders as firms distributing cash dividends. The market thus appears to have developed one signal and not the other. This development may have resulted because debt distribution throws shareholders' homemade portfolios out of balance.

33. I.R.C. §§ 305, 306 (1982).

what now has the appearance of a dividend, but this complexity need not concern us.<sup>34</sup> For purposes of this analysis, one must note only that preferred stock is treated more kindly than debt. Tax law makes each form of financing attractive at formation, but has less patience for bonds than for preferred stock that is distributed by the ongoing corporation.<sup>35</sup> The usual explanation for these treatments as a positive matter is adequate; Congress is said to have recognized that preferred stock can be a useful tool for providing intergenerational succession in business ownership while bonds, although equally useful in this regard, are too liquid to permit their tax-free or tax-deferred distribution.<sup>36</sup>

The treatment of preferred stock is doubly explicable if one also thinks in terms of the irrelevance proposition. Homemade leverage is possible because an investor can borrow and take a stronger equity position in a firm, but "homemade preferred stock" is not manufactured so easily. If an investor wishes that a firm have more preferred stock in its capital structure—assuming that preferred stock plays some role in the construction of an optimal portfolio<sup>37</sup>—there is little that he can do, because normally he can not find a third party who will advance funds to him under conditions that resemble those surrounding the issue of preferred stock.<sup>38</sup> In short, because homemade preferred stock is created much less easily than homemade debt, tax law can be viewed as making it easier for a firm to distribute preferred stock, rather than debt, to its shareholders.

Perhaps the most forceful objection to the claim that the tax laws concerning the receipt of bonds and preferred stock by common stockholders work in tandem with, rather than intrude upon, efficient capital markets, is that a firm always can fiddle with its capital structure by issuing more common stock (for value) or by redeeming stock. Moreover, because there is not a tax disadvantage either in distributing bonds, to existing shareholders or other investors, for fair value or in paying off debt, the firm has a number of options that enable it to engage in financial fiddling. Only some of these methods—those that involve the distribution of debt by an ongoing corporation to its shareholders for less

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34. *Id.* § 306; B. BITTKER & J. EUSTICE, *supra* note 22, ¶ 10.04, at 10-5 to -7. The centerpiece of the system provides that if the shareholder sells the stock and thus reveals that the stock is not to be held as part of a long range scheme to promote intergenerational succession, an ordinary income tax is collected to the extent that earnings and profits were sufficient for such a tax at the time the preferred stock dividend initially was distributed.

35. Tax is collected only if the preferred stock is sold or redeemed, whereas bonds are taxed immediately. The tax law could adopt a "wait and see" policy with respect to what will happen with the bonds. Such an approach would be similar to the treatment of preferred stock, but the Code does not contain such an approach. See Levmore, *Identifying Section 306 Stock: The Sleeping Beauty of Revenue Ruling 66-332*, 2 VA. TAX REV. 59, 60-62 (1982).

36. *Id.* at 61.

37. This role may be explicable in terms of agency cost theory. See Levmore, *supra* note 19, at 74-75. Of course, there may be a simple tax explanation for preferred stock in the hands of corporate investors, see R. BREALEY & S. MYERS, *supra* note 12, at 288-89, but reliance on this explanation causes the argument presented in the text to become circular.

38. The investor would need to contract for a nonrecourse loan bearing an "interest" rate that was tied to the performance of a particular firm. There is no need to continue on and imagine the homemade counterpart to a provision that grants preferred shareholders the right to elect directors in the event that dividend payments are missed, because finding someone to extend such a loan would be difficult and expensive in terms of transaction costs.

than full value—are discouraged by the tax laws. One must, however, consider the constraints under which tax jurisprudence operates. The goal of the tax system is to tax income. Any approach that did not give credit for the value given up by an investor in return for bonds or other debt would be inconceivable.<sup>39</sup> To be sure, a tax could be imposed at the firm level and the occurrence of debt financing could be made a taxable event based on the theory that such tax is a proxy for the tax on the unrecognized gain in appreciated assets. Nevertheless, the question remains: which borrowers should be taxed? If all borrowers are taxed, including firms at the time of their formation, tax law *will* intrude upon attempts to minimize agency costs through careful arrangement of capital structures. Debt financing will be discouraged, notwithstanding the absence of any reason to believe that it is efficient to discourage debt and encourage equity. Additionally, if only corporate borrowers are taxed, pooling of capital will be discouraged inefficiently. Finally, if borrowing is taxed, but section 351 continues to favor corporate borrowing at the time of formation, firms may dissolve inefficiently or sell their assets to firms that are in the formation stage. Such a system would cause more pressure to be exerted in an area where the corporate tax system has the most difficulty, namely the treatment of liquidation-reincorporations.

Even more difficult to imagine is the tax law's interfering with the issue and distribution of equity shares which form the denominator of the debt-equity ratio. The inefficiencies of various alternatives are obvious enough and, as a legal matter, one only need note that even the nontaxation of pure stock dividends has a history that borders on constitutional invincibility.<sup>40</sup> In sum, while only radical changes in tax law would leave firms and investors entirely free to arrange capital structures in ways that minimize agency costs, one can argue that *within* its own historically and economically determined confines, tax law supports, rather than intrudes upon, the practical lessons of modern financial theory with regard to capital structure.

### III. THE POSITIVE ROLE OF TAX LAW IN STOCK AND ASSET ACQUISITIONS

Consider the tax treatment of an acquisition of a target, *T*'s stock by an acquiring corporation, *A*. Assuming that *A* pays cash, or that it uses its own stock to effect this acquisition, but intentionally fails to meet the requirements for a tax-free reorganization,<sup>41</sup> there are means by which *A* can receive credit for its purchase price toward the tax cost of "stepping up" the basis of *T*'s assets for depreciation purposes. If *A* had purchased *T*'s assets rather than

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39. Taxing someone who invests \$300 and sells out for \$600 differently than someone who begins with \$100 and emerges with \$400 would be terribly odd and inefficient. Of course, the best method of giving credit for investment is less obvious. See M. CHIRELSTEIN, *supra* note 26, at 25-28.

40. Cf. B. BITTKER & J. EUSTICE, *supra* note 22, ¶ 7.60, at 7-41 to -44.

41. Some acquirers, in effect, will be able to choose whether to "reorganize" with the target and inherit most of the target's tax attributes including asset basis on which depreciation deductions are figured, or to purchase the target's assets or stock and allow the target to step-up (or force it to step down) its asset basis for depreciation purposes. Other advantages and disadvantages, such as the recapture of prior deductions, also may be at stake in this choice. Roughly speaking, the latter (step-up through purchase) route requires a tax on previous appreciation, while the reorganization route can allow the continuing nonrecognition of gain.

equity instruments, this step-up would have been automatic. Thus, any means provided by tax law for asset step-ups in stock acquisitions should be considered as an attempt to be neutral or non-intrusive. If *A*'s ability to step-up asset basis is limited to one method of acquisition, tax law will have intruded on this important business decision.<sup>42</sup> When *A* purchases less than eighty percent of *T*'s stock, or when *A* is an individual, the step-up of *T*'s assets is easy—although under the Tax Reform Act of 1986 it may be unattractively expensive to effectuate such a step-up. *A* simply liquidates *T*. This liquidation is an occasion for recognition and normally generates a tax at the shareholder level under section 331 as well as a step-up in the assets' bases under section 334. However, the recognition is painless because *A*, having just purchased *T*'s stock from shareholders of *T* who will have paid tax on any previously unrecognized appreciation when selling these shares, will have no gain to report on the shares of *T* that are exchanged in liquidation. Under new section 336 of the Tax Reform Act of 1986, the liquidation also will trigger a corporate level tax so that the step-up requires the payment of a second tax, or "asset tax," in addition to the "stock tax" paid by these who sold shares to *A*. Because of the absence of a preference for capital gains—under the initial rules of the 1986 Act—an acquisition and liquidation of the sort just described would require unusual tax circumstances or expectations or a strong nontax motivation.

As every student of corporate tax knows, special Code provisions are needed only when an acquiring corporation owns 80% or more of *T*'s stock. The liquidation of *T* in such situations is a tax-free reorganization, with no step-up in asset basis.<sup>43</sup> Section 338 works in this setting to preserve neutrality between stock and asset acquisitions. The analysis could stop here, sketch section 338, and repeat the main point about the positive role of tax law: the idea that section 338, like its predecessors was designed to ensure that acquirers and sellers would not be limited to one form of acquisition strongly supports the point that tax law works hard to avoid intrusions. Indeed, this small area of tax law in which corporate acquirers of stock are entitled to step-up the bases of assets, and are not, therefore, discouraged from stock—as opposed to asset—acquisitions is an excellent example of the positive role stressed in this Essay.

However, the role played by section 338 is deeper, richer, and more striking than what first meets the eye. The rather intricate mechanics of section 338 contain less obvious evidence about the positive interaction between tax and corporate law. These mechanics, summarized presently, are understood most easily if one bears in mind that the Code's treatment of business sales, at least through 1986, generally has been to collect one full tax on all unrecognized appreciation or gain and to give in return a full step-up in the basis of assets to the level of present fair market value. In the case of these stock acquisitions, one should be mindful of the contributions toward this tax collected from the past and present shareholders of *T*. Although the Tax Reform Act of 1986 now collects *two* taxes in most acquisitions, as the price of a step-up, section 338 continues to play a substantial part of the role that it played in the one-tax scheme.

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42. If asset acquisitions are more attractive than stock acquisitions, incumbent managers will have greater power to prevent takeovers or demand side-payments for their role in enabling such takeovers.

43. I.R.C. §§ 332, 334(b) (1982). See also Tax Reform Act of 1986 § 337. I.R.C. § 337 (1986).

In the pages that follow, an argument about the positive role of tax law in terms of the rules in place *prior to* the Tax Reform Act of 1986 will be presented. A related and equally intricate argument about the post-1986 rules is developed in the margins.<sup>44</sup> The reasons for dwelling on these rules are several. First, the argument is a bit more elegant under the older rules, and the purpose of this Essay is to explore the nature of the interaction between tax law and corporate law, rather than to sketch the latest rules on corporate acquisitions. The occasional notes should assist the purist who wishes to reformulate every aspect of the argument in terms of the 1986 Act. Second, because the Tax Reform Act of 1986 essentially imposes two taxes, rather than one, on complete corporate acquisitions, the details of the argument are made more complex by the Act. As will be apparent below, the matter is complicated sufficiently with one tax in tow. Finally, and not unimportantly, the old rules are by no means obsolete. A substantial number of transactions initiated before August, 1986 are grandfathered and treated under the old rules.<sup>45</sup> Moreover, the old rules apply until 1989—and may, of course, be extended—for target corporations that have fifty percent of their stock held by ten or fewer individuals, including trusts and estates, and whose value is less than five million dollars. Corporations worth more than five but less than ten million dollars are entitled to some of the old (one-tax rather than two-tax) treatment on their liquidation.<sup>46</sup> In short, not only will the argument be easier to follow in one-tax terms, but also the one-tax *General Utilities*<sup>47</sup> world will continue to exist for some time, even if no future legislative changes return us more completely to its rules.

#### A. Section 338

Section 338 operates<sup>48</sup> in the following manner. First, if corporation *A* buys 100% of *T*'s stock, *A* can elect to step up the basis of *T*'s assets, as if the assets were sold, without paying any tax.<sup>49</sup> Note that all those who sold stock to *A* will pay taxes on their gain. SEcond, if *A* buys between 80% and 100% of *T*'s stock, there is a full 100% step-up as if all the assets were sold in a taxable transactions but *T*, now controlled by *A*, must pay tax on the hypothetical sale of these assets according to how many old *T* shareholders have *not* sold—and therefore not paid tax on appreciation in—stock to *A*. Thus, if *A* buys 85% of *T*'s stock and elects under section 338, there is a complete step-up of *T*'s assets, but *T* must pay 15% of the tax that would be due if all of *T*'s assets were sold in a taxable transaction. If *A* buys 95% of *T*'s stock, there is an

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44. See *infra* note 56.

45. Tax Reform Act of 1986 § 633(c).

46. *Id.* § 633(d).

47. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

48. I.R.C. § 338 (1982). Section 631(b)(2) of The Tax Reform Act of 1986 repealed § 338(c) and, therefore, the mechanism described in the text as contained in § 338. The use of the present tense in the text's description of § 338 must be understood as applying to small or grandfathered corporations. See *infra* note 56 for a more complicated argument, applying the rules in § 338 after the repeal of subsection (c).

49. Under § 631 of the Tax Reform Act of 1986, which repeals the *General Utilities* rule that had forgiven corporate level recognition of gain upon liquidation, there will be a corporate-level tax under § 338(a)(1). The discussion *infra* at note 56 includes this tax.

“asset tax” on 5% of the asset appreciation, and so forth. Finally, for those who do not follow corporate tax law but would like to know that the system is comprehensive, if *A* buys more than 80% of *T*'s stock and has purchased some *T* stock at some time in the past, it still can choose a complete step-up in *T*'s assets, but must pay tax on appreciation in its own old holdings of *T* stock. The basis in these holdings also is stepped up.<sup>50</sup>

I will argue that these rules are sensitive to the decision making processes that surround tender offers, but it is useful first to sketch the alternative means by which section 338 could have allowed a step-up in basis in order to maintain neutrality between asset and stock acquisitions in return for one tax. Instead of giving a 10% step-up in return for less than a 100% stock purchase, and collecting the balance of the tax in the form of an “asset tax” from the corporation, the Code, instead, could have chosen to give a step-up only to the extent that a tax has been collected from the shareholders who sell to *A*. When *A* purchases 85% of *T* stock, for example, an 85% step-up would follow. Recall that section 338 gave a 100% step-up in these circumstances and collected a 15% asset tax from *T*. The alternative is to collect no such “asset tax,” but simply to give an 85% step-up. We might label this “Alternative 1.” Note that the rules of Alternative 1 might permit the acquirer to freeze out the remaining shareholders and, in return for the taxes they pay on selling these shares, enjoy a full step-up in *T*'s assets.

The approaches found in section 338 and described by Alternative 1 both suffer from what can be called a “correspondence fallacy” that lurks throughout much of corporate tax. Unrecognized gain is unlikely to be distributed evenly across the outstanding stock of a firm. The amount of unrecognized gain represented, for example, in ten percent of the outstanding stock of a company is not likely to equal the amount of unrecognized gain in ten percent of that firm's assets. When *all* the stock appreciation is taxed, the government can be sure that it has received the equivalent of a tax on all asset appreciation because the market value of the stock presumably represents, at least, the value of all the assets held by the corporation. However, when less than all the stock has been traded and taxed there is no way of knowing in the abstract what part of the overall unrecognized gain contained in all the stock or all the assets is in this subject of the stock. Indeed, because old shares with significant untaxed appreciation are the least likely to be traded on a given day, a scheme that steps up assets according to the percentage of stock that is traded recently will provide opportunities for step-ups too cheaply when compared to the treatment of a 100% stock sale and step-up. Moreover, taxpayers surely will take advantage of the correspondence fallacy and adversely select against the fisc by electing under section 338, or Alternative 1, readily whenever the unsold stock contains a disproportionately high share of unrecognized gain. Inefficient acquisitions also might be generated by such rules because tax advantages in the form of depreciation deductions from higher bases would be available from otherwise inefficient, unprofitable transfers of control when unrecognized gain is contained disproportionately in relatively few unsold shares.

To see this correspondence fallacy, assume that a firm, *T*, begins with 10 shares owned by *A* Corporation, and \$10 invested in a machine, but that over

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50. I.R.C. § 338(b) (1982). This feature of § 338 survives the 1986 Act. See *infra* note 56 for some discussion of the 80% requirement of § 338.

time both become worth \$1,000 because of inventions or marketing by employees of the firm. *T* now sells ninety shares to new investors, who contribute \$100 in assets for each share. Each share will represent a 1/100 claim on an enterprise now worth \$10,000. If, after a year with no further appreciation, the ninety new shareholders all sell their stock to *A*, they will have no gain to report. *A* can now make a section 338 election. Under the rules of section 338, *T* will need to pay, on behalf of the nonselling shareholders, 10% of the tax that it would have paid in a complete and taxable asset sale (10% of \$990). The machine's basis is stepped up completely to \$1000 even though only 10% of its appreciation has been taxed. This is the correspondence problem inherent in section 338.

Under Alternative 1's rules, the correspondence problem is at least as great as under pre-1986 section 338. The machine would be stepped up by 90% of the full differential between the adjusted basis, \$10, and the fair market value, \$1000, or from \$10 to \$901 with no tax cost at all. Superficially, the correspondence fallacy is the same under this method as it is under section 338. Both approaches might be said to give the first \$891 of step-up at no tax cost, but under section 338 the corporation must continue and take another \$99 step-up at the cost of a corporate-level tax on \$99 of gain. Sometimes this extra step-up will be welcomed by the taxpayer, perhaps because some depreciation schedules are friendly to investment. However, sometimes the tax, and step-up, will be unwanted because it involves an immediate tax liability with consequent depreciation deductions available only in later years. Finally, sometimes the extra step-up will be a matter of indifference because the advantages of increased deductions and the disadvantages of a present tax liability will be offsetting. My own sense is that the two methods often will be roughly equal from the perspectives of the taxpayer and the government, but that in a significant subset of acquisitions the loss to the government arising out of the correspondence fallacy is likely to be less under the method actually employed in section 338 than under Alternative 1. Stated differently, taxpayers in the aggregate would prefer Alternative 1, earning a step-up to the extent that stock changes hands. The section 338 rules, in contrast, force additional gain recognition. There is reason to think that taxpayers generally prefer to have maximum control over the timing of recognition and the section 338 technique removes from taxpayers some of their control over the timing of recognition. In short, the two methods may generate equal correspondence fallacies, in which case the choice of the technique actually used in section 338 simply can be regarded as a matter of indifference. On the other hand, one might estimate that the correspondence fallacy in Alternative 1 (that is, step-up according to purchase, and no more) is greater than that in section 338, in which case the statute can be understood as reflecting a decision to minimize the correspondence problem.

The correspondence problem might have been avoided altogether, while collecting a full tax and giving a complete step-up in a manner alluded to in the 1982 changes to the Code and suggested by a case that was regarded widely as too harsh to nonselling minority shareholders.<sup>51</sup> This approach, which might be labelled "Alternative 2," would permit a full step-up of *T*'s assets even when

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51. *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd without opinion*, 491 F.2d 749 (3d Cir. 1974).



A has bought less than 100% of T's stock, and would collect a tax from the non-selling shareholders of T rather than from T itself. By imagining and forcing these nonselling shareholders to sell their T stock to themselves and to recognize gain, the correspondence fallacy is avoided because there is 100% recognition.

With Alternatives 1 and 2 and the notion of the correspondence fallacy now set out we are positioned to consider the interaction between the mechanics of section 338 and the dynamics of the market for corporate control. The nonselling shareholders—as opposed to offerees in general—surely will be pleased to learn that the drafters of section 338 did not opt for Alternative 2. Alternative 2 would be unattractive to such shareholders because, in contrast to the normal tax law rules that allow the individual to decide on the timing of such recognition, it would force gain recognition. In some settings, these nonselling shareholders may have dissented from, or turned down, and acquirer's offer for their stock precisely because the tax consequences of a sale made the offer less attractive than it was to most other shareholders. Here, the ability to control the timing of recognition is relatively clear.

A difficult question is whether economic efficiency would be promoted by Alternative 2's insensitivity to the nonselling shareholders' personal tax consequences. Arguably, the market for corporate control works best when owners freely decide whether to accept an offer, await other offers, or hope that current management over time will cause shares to be worth even more than what a bidder offers presently. Inasmuch as tax law, by collecting revenue when there are recognition events, *already* intrudes on this decision, this distorting, inefficient intrusion possibly could be neutralized by a rule that withdraws from the shareholder the ability to trigger or prevent such a recognition event. Stated differently, nonselling shareholders may have good tax reasons to turn down offers for their shares, but society's interest could be served best by encouraging a decision on each offer that is unaffected by tax considerations. Therefore, Alternative 2 may be good for the market despite the fact that it is costly to some individuals.

A problem with this argument is that it tries to stop short of repeating the familiar notion that the tax system would be less intrusive if changes in wealth or consumption were assessed daily or yearly rather than calculated only when certain recognition events occur. Shareholders may reject offers from acquirers, who signal with their generous offers that they could put the firm's assets to more productive use, simply to postpone their personal tax liability; a smaller amount of money taxed later, unfortunately, is more attractive than more money taxed now. But, what are the alternatives to the present regime? Alternative 2 may generate perverse behavior because targets, acting through their managers, may resist acquisitions more vigorously in order to avoid tax liabilities. Some shareholders may be able to pay or influence the firm to behave in this way, whereas, without Alternative 2 they will have less reason to care about the responses of their fellow shareholders. More generally, Alternative 2 does not necessarily cause offerees to ignore taxes and to focus on "real" things, because if enough shareholders decline the offer, no qualifying acquisition will take place and section 338, like Alternative 2, can not be triggered. Nor can this distortion in the responses of offerees be avoided by decreeing that all offers of acquisition trigger a stock tax, so that target shareholders do not include tax considerations in the calculus of their responses; it is simply too difficult to distinguish true offers from strategic offers. Any further step

in this direction is nothing more than a call for daily recognition of gain and is so far removed from the norms of the present tax system that it is best left unconsidered in this Essay.

Alternatives 1 and 2 are thus relatively unattractive. Alternative 1, which would allow a step-up only to the extent that taxes have been collected from selling shareholders, is undesirable because the correspondence problem probably is greater under its terms than under those of section 338. Alternative 2, which would give a full step-up but would assess taxes against all nonselling shareholders similar to those collected from sellers, also is unattractive, not only because as a matter of legal tradition, it suggests the unthinkable<sup>52</sup> and forces shareholders to recognize gains or losses in a way that seems unfair in the context of a system that normally allows taxpayers to control the timing of recognition events, but also because it might cause targets to resist outside offers even more than they do under existing tax rules.<sup>53</sup>

### *B. The Positive Role of Section 338*

With all this in mind, the design of the second prong of section 338 itself can be reexamined. We have seen how section 338 compromises on the correspondence problem,<sup>54</sup> but there has been no discussion of section 338's effect on offerees' inclinations to accept or reject offers for their shares. At first glance, the design of section 338 seems flawed because when the corporate-level tax on appreciated assets is paid "on behalf of" the less than 20% nonselling shareholders, no step-up or other credit is given to these shareholders, so that there is potential for overtaxation in comparison with the complete stock or asset sale norm. For example, if *T*'s assets have risen in value from \$100 to \$200, if *T* has 100 shares outstanding each with a basis of \$1 and fair market value of \$2, and if 80 of the 100 shares of *T* stock were sold to *A* who elects under 338, *T* will pay tax on 20% of the \$100 asset appreciation. If the nonselling shareholders sell their stock to *A* or some other purchaser shortly after the original sale to *A*, they will pay tax on their gain. Thus, the government could collect tax on \$80 from the first group of selling shareholders, \$20 from *T* after the 338 election, and \$20 from the second group of originally nonselling shareholders. This results in a total tax of \$120 when only \$100 would have been taxed in a normal stock or asset sale. Section 338, contrary to its obvious purpose, thus intrudes upon the choice between an asset and stock acquisition, because the tax assessments associated with the latter can be more expensive.<sup>55</sup>

Having examined the alternatives to the second prong of section 338, it becomes apparent that the failure of section 338 as just described may simply be the least of all evils. Allowing those minority shareholders who eventually

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52. See *supra* text accompanying note 39.

53. That is, the rules contained in (now repealed) § 338(c), giving a full step-up, but requiring an asset tax from *T* "on behalf of" the nonselling shareholders.

54. See *supra* text preceding note 50.

55. The tax liability also *could* be lower because of a combination of the correspondence problem and deferral. However, taxpayers can be expected to select adversely against the fisc. Note that even this imperfection sometimes will be avoidable after an 80% acquisition, because the acquirer and the nonselling shareholders may be able to strike a deal to liquidate within a year, in which case the nonsellers will upon liquidation pay a tax and, appropriately, § 338(c)(1) will forgive the asset-based tax that otherwise would be collected from the target in return for the full step-up.

sell their stock to avoid taxation, or, equivalently, giving the nonselling shareholders a step-up in the basis of their stock in T when a partial asset tax is paid "on their behalf" by T would be unacceptable. Such treatment would encourage offerees to reject an offer—even when it is one they think beneficial—in the hope that the offer would succeed at the 80% level and, then, be followed by a section 338 election. This set of events not only would allow those who turn down the offer to benefit by paying less than their proportional share of the tax cost of a full step-up in the corporation's assets, but also would give them a tax-free sale of their stock. Any hope of neutral, efficiency-enhancing responses to offers, or responses not influenced primarily by tax considerations, therefore, depends on treating nonsellers no better than sellers. In addition, because the alternatives to section 338 also are flawed, one can argue that the imperfection of section 338's step-up technique, including the potential for overtaxation, is, in fact, the least of all evils.<sup>56</sup>

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56. The Tax Reform Act of 1986 deleted § 338(a)(1)'s reference to old (repealed) § 337 and § 338(c), which had contained the rule requiring A to pay an asset tax on behalf of non-selling shareholders. Under the new rules, if A purchases 100% of T stock and elects under 338, T's assets are stepped up in return for a complete asset tax on the appreciation of these assets in T's hands. Although the Code generally frowns on "self-triggered" recognition, *see, e.g.*, § 1239, it is reasonable for the Code to allow this self-triggered step-up, because the fair value of the assets is determined accurately by referring to the price just paid by A for all of T's stock.

The more serious design problem is the treatment of a purchase by A of, let us say, only 80% of the T stock. It is useful to think of the following five possibilities and the attendant advantages and disadvantages of each.

(1) The Code could deny any step-up in T's assets, despite the collection of a full asset tax, on the grounds that it can be reckless to extrapolate from the price paid for 80% of the stock to the fair value of 100% of the assets of a firm. A might even find it worthwhile to overpay for the 80% stock in order to generate a high basis. For example, if T is worth \$85,000, A might pay \$80,000 for 80% of T's stock and claim that a straight line extrapolation indicates that \$100,000 is the apparent value of 100% of T's stock and, therefore, of all T's assets. On the other hand, the denial of any step-up following an 80% stock purchase would deter acquirers from stock acquisitions and, therefore, endow targets' managers with great power to extract payments and promises in return for the engineering of asset sales.

(2) The Code could pick some dividing line, such as 80%, and allow 80% stock purchasers to extrapolate and step up 100% of T's assets in return for a full (anti-*General Utilities*) asset tax and the 80% "stock tax" paid by the selling shareholders. Stated differently, while allowing a full step-up in the case of a 20% stock purchase (in return for a full asset tax and a 20% stock tax) would overly encourage stock purchases by acquirers who sought advantage from both the extrapolation technique and from the correspondence fallacy, in the case of an 80% purchase it is arguable that the extrapolation and correspondence problems are relatively small and are more than offset by the advantages of enabling some (less than 100%) stock acquisitions as an alternative to asset acquisitions. Withholding step-ups from all but 100% purchasers would give great holdout power either to target managers or to minority target shareholders.

(3) The Code could collect two full taxes by levying an asset tax on T, once again, and requiring all nonselling T shareholders to pay tax and step up their stock bases as if they sold their shares. This is a harsh rule although it *would* promote neutrality between stock and asset acquisitions.

(4) The Code could collect a full asset tax and then grant a step-up to the degree that stock is sold and taxed. An 80% stock purchase would thus enable T to step up its assets 80% of the way from their old adjusted basis to their present fair market value—determined, once again, by extrapolation from the 80% purchase.

(5) Finally, if method (3) seems too harsh, either because of the tradition of awaiting voluntary recognition events or because when A buys T's assets only one tax need be paid in order to enjoy an asset basis step-up (the stock tax is due only when money is received by shareholders), methods (2), (3), and (4) can be compromised. The Code could extrapolate from the 80% purchase to give a full step-up as in (2) so long as a full asset tax is paid, but withhold this step-up to the extent

I suppose that it might have been slightly more elegant for the statute to provide a 100% step-up, collect an asset tax from the target "on behalf of" the nonsellers, *and* give the nonsellers a "corresponding," rather than a full, step-up in their stock basis linked to the asset tax paid by the target. Some overtaxation would be prevented by this "Alternative 3," and yet no incentive to dissent would be created.

Imagine, for example, that every one of the ten shares of a target has a basis of \$10 and a fair market value of \$100, that its assets have appreciated from \$100 to \$1000, and that only one share is not sold to the acquirer who elects under 338 with Alternative 3 incorporated. Alternative 3 provides a full asset basis step-up, extracts a tax on \$90 (\$100 minus \$10) from the nine shareholders (\$810 total), collects a corporate-level tax on 10% of the \$900 asset appreciation, and, unlike actual section 338, gives the nonselling shareholder a basis in his stock of \$19. This step-up of \$9 is equal to the 10% proportion of the \$90 asset appreciation taxes to the corporation because of the nonseller. This corresponding, or partial, stock basis step-up probably is insufficient to encourage more dissent or nonselling than is already influenced by section 338, because in dissent, under the rules actually contained in section 338, one might indirectly pay a greater part of the asset tax paid on behalf of nonsellers.<sup>57</sup>

Had Alternative 3 been chosen by the tax law, one could not overstate the positive interaction of corporate law and tax law in the context of acquisitions. Inasmuch as section 338 contains rules very similar to Alternative 3 and is much less complicated administratively,<sup>58</sup> I feel comfortable arguing that section 338 is an impressive example of the positive role of tax law. Not only does section 338 aim to give acquirers the flexibility of choosing between asset and stock acquisitions, but also the mechanics of stepping up asset bases in stock acquisitions reflect remarkable sensitivity to the dynamics of stock sales. The Code appears elegant and efficient rather than intrusive.

#### IV. CONCLUSION

One could not claim that taxes do not intrude upon or distort decisions that take place in corporate and capital markets.<sup>59</sup> I have tried to suggest in

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that *A* itself owns the nonselling stock (as in (4))—unless *A* pays tax on the unrecognized gain in these shares (as in (3)). Remarkably, this most complicated alternative is precisely the current pattern of § 338(a) and (b). For example, if *A* bought 10% of *T* stock some years ago for \$10 and now it buys 80% more for \$160, and elects under § 338, it is given a step-up to \$190. *T* is entitled to a basis of 200 in its assets only if *A* recognizes gain on the extrapolated increase in value of its old *T* stock (20 minus basis of 10).

I suspect that some of this is the patchwork remains of the recent round of tax reform, and that in the future § 338 will evolve to look more like method (2) and less like method (5). Nevertheless, the positive role of tax law is quite striking. Both methods (2) and (5)—that is, current § 338—reflect a compromise between sensitivity to the extrapolation and correspondence problems, on one hand, and, on the other, an appreciation of the need to leave open both the asset and stock acquisition routes in the market for corporate control.

57. I.R.C. § 338(c)(1) (1982).

58. Frequently the Code utilizes what conceptually is a second-best solution because the optimal solution is available only at a higher administrative or articulation cost.

59. Even if current stock prices reflect all pertinent factors, the fact remains that at the margin the tax system's preference for recognition, rather than periodic appraisals, affects the decision to hold or sell an asset.

this paper that alongside these intrusions there also is positive interplay. There is reason to think that the positive interactions described in this Essay are not accidental in the evolutionary sense, either because the drafters of the relevant Code sections knew just what they were doing or, more likely, because they could perceive some weaknesses in the available alternatives. On the other hand, the more one can explain those areas of tax law that interact positively with various policy goals, the more mysterious or troubling are those areas in which taxes appear to be violent intruders. But whatever the explanation of the positive role of tax law, the study of positive interactions between tax and other law will assist reformers who, when trying to minimize the intrusions of tax law, need to understand that tax and other law are sometimes complimentary.