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I. INTRODUCTION

The Internal Revenue Code (IRC)[1] contains some exceptional rules applying to corporate structural changes. These rules grant preferential tax treatment to a significant volume of merger and acquisition (M&A) transactions.[2] Nevertheless, it is hard to establish a clear and comprehensive rationale for the current rules, which should be surprising but is not so to any student of the material. Oddly enough, these rules are some of the most stable foundations of the federal tax system despite their shaky normative grounds. In this Article, I propose to repeal these rules and to tax "reorganization" transactions[3] like all other sales or exchanges. I reject the stated rationale for these rules—that such transactions trigger insufficient realization and, therefore, that it is both unfair and impractical to currently tax them. I further demonstrate that the preferential tax treatment of reorganizations cannot be supported on efficiency grounds.[4]

In certain circumstances, the reorganization rules allow some taxpayers not to recognize (and therefore not to be currently taxed on) the gain they realize in these transactions. The "price" of such

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1. Unless otherwise provided, all references are to the IRC and the Treasury Regulations prescribed under it.

2. *See* I.R.C. §§ 354, 361, 368 (2000).

3. In this Article, I loosely use the term "reorganizations" to describe corporate structural changes that benefit from preferential tax treatment, following the § 368 definition of such transactions, but my definition is not in complete accordance with the substantive content of § 368.

4. Although efficiency has not been explicitly stated as a justification for these rules, it has been raised indirectly as if it were an incontestable advantage of the reorganization provisions. *See infra* Part III.

nonrecognition is usually some sort of carry-over tax basis, which, in effect, results in tax deferral and a timing preference for these taxpayers. For example, consider T, an individual inventor and a 100% shareholder of InventCorp, a Delaware corporation that has developed and secured a patent on an invention. T agrees to merge InventCorp, under Delaware law, into IBM in exchange for one million dollars' worth of IBM stock. Pursuant to the reorganization rules, T will not be taxed upon the transaction. Assuming normal start-up circumstances, T's realized gain of close to one million dollars may be deferred until she disposes of the IBM stock received in the transaction, her basis in which is transferred from her InventCorp stock forgone in the merger.[5] Note that if T received one million dollars in cash in the merger, or if she had developed the invention in her capacity as an individual, she would be currently taxed on her entire gain. This (deferral) preference may translate into indefinite deferral and to partial or complete avoidance of the tax.[6] Nevertheless, this preference has been established over the last eighty years as a cornerstone of the federal income tax system.

In this Article, I focus only on the primary acquisitive reorganizations: the type A statutory merger, the type B stock-for-stock acquisition, and the type C assets-for-stock acquisition. The rules governing corporate structural changes include a wide variety of other transactions that have many similar features for tax policy purposes,[7] but the analysis of which must be deferred for methodological and simplification purposes.

The common feature of all reorganization transactions and, as we will see shortly, the stated justification of the applicable tax rules, is that in these transactions either the core ownership group or the core business, or both, remain substantively the same but undergo a formal change that is justified by business reasons:

5. Her basis amount is probably a negligible amount equal to her investment of money and property in InventCorp. I ignore this amount in this Article and consider it to be equal to zero.

6. Complete avoidance was even easier prior to the 1986 repeal of the *General Utilities* doctrine. Gen. Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935). *See also* Eric M. Zolt, *The* General Utilities *Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819 (1987).

7. These are the rules applying to the organization of corporations (§ 351), termination of corporations in certain circumstances (§ 332 and § 337), and some other basic transactions affecting structural changes of corporations, primarily those falling into the definition of a "reorganization" (§ 368).

> The traditional theory . . . is that gain or loss should not be recognized on changes of form when the taxpayer's investment remains in [the] corporate solution or when "a formal distribution . . . represents merely a new form of the previous participation in an enterprise involving no change of substance in the rights and relations of interested parties one to another or to the corporate assets."[8]

The courts and the business community have never questioned the logic of these rules. The government has attempted, from time to time, to analyze some of their specific details, but except for a short episode in the 1930s, it has not made a serious attempt to conceptually revise, or even review the normative foundation of, these rules. The legislature has consistently concentrated on shutting down abuse potentials rather than questioning the basic premises behind this tax regime. The result is an extremely stable (but stagnant) regime that is resistant to change despite its inadequacies, which are exposed mainly by academics.[9] The resulting system, described by one scholar, consists of "a variety of patterns of taxation [that] have emerged through largely uncoordinated, ad hoc legislative and judicial development . . . containing unsupportable distinctions and inconsistencies, [which are] massively complex."[10] This harsh description is not surprising to anyone exposed to this notoriously "complex and cryptic"[11] regime, but general industry satisfaction has evidently been sufficient to ensure the retention of this major part of the tax law.

Part II follows with an analysis and rejection of the stated realization-based rationale for the reorganization rules. It demonstrates that the reasons for adopting the realization requirement itself—mainly liquidity concerns and valuation hardship—are either irrelevant or cannot support the argument that the tax preference to reorganizations is necessary to maintain the

8. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.01[3] (7th ed. 2000) (citing in part Bazley v. C.I.R., 331 U.S. 737, 740, *reh'g denied*, 332 U.S. 752 (1947)).

9. Jerome R. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254, 276 (1957); William A. Lovett, *Tax Subsidies for Merger: Should Mergers be Made to Meet a Market Test for Efficiency?*, 45 N.Y.U. L. REV. 844 (1970).

10. Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 146 (1989).

11. Milton Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98, 98 (1938).

integrity of the realization requirement as a fundamental feature of the federal income tax.[12]

Part III analyzes the argument that another purpose of the reorganization provisions could have been the generation of efficiency benefits. This argument, normally stated in negative terms, has been that without these rules the tax system would have restricted socially beneficial transactions.[13] In this Part, I first reconstruct and then challenge this argument, which has not been methodically established in legal academic literature. Fortunately, there is a significant body of economic, business, and corporate law M&A literature that provides empirical and theoretical bases for this analysis. I also try to set a reasonable framework for future study of this issue. The conclusion of this analysis is that efficiency justifications cannot support the current reorganizations rules since these rules apply to (and benefit) only some M&A transactions, which may not necessarily be the most efficient M&A transactions. Moreover, it is likely that these rules do not actually play a significant role even in the materialization of the transactions they are supposed to encourage. Their effect, therefore, is that of a subsidy to certain participants in M&A transactions—an arbitrary, unfocused, and hard-to-justify subsidy. In light of the significant costs and ineffectiveness of such a subsidy, it is unlikely to be efficient.

Finally, Part IV concludes with a proposition to completely repeal the reorganization provisions. I suggest that this will result in significant simplicity and efficiency gains, and that such a repeal is

12. I base my analysis on the conclusions I reached in my historical analysis presented in the Appendix for the benefit of the inexperienced tax reader. The Appendix reviews the historical development and evolution of reorganizations. It further presents the few criticisms of this regime as developed throughout the years. The argument that the reorganization rules evolved through a rigid prism of a realization-based income tax, devoted to the maintenance of realization as the fundamental feature of the system, was first observed by Professor Bank. Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1 (2000). Bank disposed of other rhetorical and historical arguments for reorganization rules, including the contention that pressure to revive the depressed post-World War I economy resulted in many measures, including easement of taxation of business and business combinations. One of these measures was the enactment of the reorganization provisions that have remained substantially unchanged, many years after those harsh economic pressures. *See also* Lovett, *supra* note 9, at 852.

13. The argument is implied in the legislative history and the academic literature. Lovett, *supra* note 9, at 851–52.

not unfair. Standard policy grounds cannot support the current regime, which adds substantial complexity to the tax system.[14]

This Article is based on some strong assumptions. It assumes no critical change in the current U.S. status quo regarding the optimal size of the government, as well as the retention of the income tax and its current realization-based version as the primary federal method of taxation.[15] Additionally, I assume that the United States will continue to insist on preserving the classical corporate tax.[16]

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14. I note that it is a mistake, from a policy perspective, to keep an unjustified current regime just because we are short of effective, predictive tools to choose the "best" of available alternatives where we do know that all of these alternatives are better than the current regime.

15. For example, I am assuming that there will be no switch to a federal consumption tax. *See, e.g.*, ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM (Henry J. Aaron & William S. Gale eds., 1996) (discussing various proposals for U.S. tax reform); JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 199–236 (2000) (reviewing and summarizing the advantages and disadvantages of different U.S. proposals).

16. It may be useful to clarify the importance of this last assumption. Clearly, corporations serve a central role in the current western economy. More than half of the U.S. GDP originates in real corporations. COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 306, 322 (2000), ***available at*** http://w3.access.gpo.gov/usbudget/fy2001/pdf/2000_erp.pdf. Corporations are fictional "legal entities," treated ambivalently by the law. In some circumstances, their legal treatment equals the treatment of real (flesh-and-blood) persons, and in others, it differs. Similar ambivalence exists in tax. The rhetoric of the corporate tax is that it taxes corporations as separate legal persons. This is the essence of a "classical" corporate tax system. Nevertheless, the IRC has a separate and different set of rules for this tax—with independent tax rates, brackets, etc.—for corporations (i.e., corporations are not actually taxed as if they were human). This lack of consistency is hard to justify intelligently. The current corporate tax is the product of sets of rules developed and tampered with over the years depending on the political and economic setting. It is important to remember, nevertheless, the revenue scope of this tax. It accounts for no more than fifteen percent of federal tax collections. CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005–2014 tbl.F-3 (2003), ***available at*** http://www.cbo.gov/showdoc.cfm?index=1821&sequence=0. Interestingly, the pattern I show here with respect to reorganizations, i.e., staple rules without sound rationale or rigid origiual assessment of the reason for their legislation, is similar to the pattern seen in the legislation of the corporate tax itself. *See* Robert Clark, ***The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform***, 87 YALE L.J. 90, 97 n.20 (1977). What is wrong with the corporate tax? In principle, we all know that corporations, being fictional, do not pay taxes, only real people do. This cliché means that only flesh-and-blood persons can bear the economic burden of taxation. The corporate tax, therefore, distorts the choice of organization form. For further insights, see Hideki Kanda & Saul Levmore, ***Taxes, Agency Costs, and the Price of Incorporation***, 77 VA. L. REV. 211 (1991). Then what is the corporate tax? One way to look at it is as a means of collection, like a withholding tax system. In a similar sense, it supports the integrity of the individual income tax in that it does not generally tax retained earnings of the corporation at the level of the shareholders at the time these earnings are generated, Clark, ***supra***, at 101–03, although this is, obviously, not a necessary feature of the system. Another common justification for the corporate tax is that it compensates society for certain special privileges it provides corporations, mainly the limited liability for shareholders.

The various regimes in Subchapter C of the Tax Code are all interwoven in their complexity and must be untangled, one by one, in order to allow real progress. This strategy allows us to ameliorate the risk of irrelevant resistance, political or otherwise. My proposal to repeal the reorganization preferences offers progress, but should not be mistaken for a tax reform proposal that amends fundamental bases of the system. Fundamental tax reforms are scarce, partly due to the effectiveness of opposition that may not be directed at the whole reform project, but rather at only some of its parts. An all-or-nothing approach (such as the inclination to adopt the whole reform or nothing) in tax may, at best, achieve a disappointing compromise;[17] in reality, it usually achieves nothing, encouraging stagnation and inefficiency.

II. THE REALIZATION REQUIREMENT DOES NOT SUPPORT NONRECOGNITION FOR REORGANIZATIONS

The traditional, stated justification for reorganization preferences arises from the intuition that the subject transactions do not trigger *sufficient* realization to justify their current taxation.[18] The federal

The most elementary, and probably the most important, justification for the corporate tax is that large corporations do operate as separate persons; they exemplify real separation of management from ownership, with little or no weight given to who the shareholders of the corporation are at any given time. This trend will only grow in extent as capital markets develop and become more sophisticated. Nevertheless, the "classical" corporate tax is clearly distortive; it is not neutral since it creates a mix of incentives and disincentives to invest in corporate business and/or capital. This and other arguments for and against the corporate tax have been extensively developed elsewhere, and several proposals to replace the corporate tax, or at least to introduce integration of the corporate tax and the taxation of corporate distributions, have been made and rejected in the United States throughout the years. *See, e.g.*, MICHAEL J. GRAETZ & ALVIN C. WARREN JR., INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS (1998). I do not attempt, therefore, to challenge the stability of the U.S. corporate tax, rather, I endeavor to challenge a particularly wasteful part of it—the corporate reorganization rules.

17. The tax reform of 1986 is a good, though clearly extraordinary, example of this argument. *See* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987).

18. Bank, *supra* note 12, at 12–13 (explaining that the favorable treatment of reorganization transactions is part of the compromise between the consumption and accretion models of taxation, which currently construct the federal tax system; and adding that given the continuous struggle between these two models, it is still a logical part of the compromise). Professor Bank mentions three arguments used to support tax-free reorganizations: (1) they are pure "paper gains" and therefore should not be taxed, (2) they are justified as a post-World War I economic revival measurement, and (3) it is administratively difficult to tax reorganizations. *Id.* He argues that, eventually, it all boils down to realization. I fully agree

income tax system is a realization-based system. It is also a mixed system—part accretion tax, taxing income arising from capital, and part consumption tax, exempting (or deferring) such income.[19] It is based on income, with significant deviations from the classical economic understanding of income,[20] primarily through the realization requirement for recognition of income and its taxation. The realization requirement has been casuistically developed throughout the years.[21] Currently, it is well established in the regulations and other administrative materials that in order to tax a taxpayer on any appreciation in the value of her property, a realization event must take place first. Such an event occurs when there is a "material change" in the investment or property held by the taxpayer.[22] In the case of T, the invention shareholder, for example, the exchange of her InventCorp stock for IBM stock constitutes such a material change and therefore is a realization event.

The realization requirement is considered necessary since without it, valuation hardship and liquidity concerns may arise and cause the system to be perceived as unfair.[23] Coming back to T, prior to the merger it may be perceived as unfair to tax her on theoretical appreciation in her InventCorp stock due to her success in completing her invention project, since, like many other entrepreneurs, she had no cash at that point in time and the value of her shares was practically impossible to accurately estimate. Nevertheless, I argue that neither of these basic justifications for a general realization requirement in the income tax system can be

with this important observation, though, clearly, not with his conclusion. *See also* Clark, *supra* note 16, at 117–18.

19. Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1 (1992).

20. This is the sum of change in net wealth, plus consumption, known as the Schanz-Haig-Simons definition of income. ROBERT M. HAIG, THE FEDERAL INCOME TAX (1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938); Georg von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1 (1896).

21. Dating back to *Eisner v. Macomber*, 252 U.S. 189 (1920).

22. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 556 (1991) (explaining that an exchange of property gives rise to a realization event when the exchanged properties are "materially different"—meaning they embody legally distinct entitlements); Treas. Reg. § 1.1001-1(a) (as amended in 1996).

23. For some time, realization was even considered a constitutional requirement by the Supreme Court; however, realization has been downgraded to an administrative convenience or, as some may say, a necessary evil. David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1552 (1998).

extended to justify an exception (nonrecognition resulting in further deferral) to the standard application of this requirement for reorganization transactions (T can easily sell her IBM shares for cash now, and the value of her shares will be determined in a market transaction). In this section, I echo past criticism of these justifications and make some additional observations that support such criticism.

A. The Prevalence of Realization as a Fundamental Concept in the Tax System and the Creation of Mixed Signals in the Reorganization Preference

A realization event does not *create* income, but rather serves as a convenient point in time at which income can be measured and added to the potential tax base of a taxpayer. It is understandable, therefore, that two concerns are constantly raised in connection with this requirement—valuation and liquidity. If the tax system does not wait for a transaction—a realization event, well defined in both time and real terms—it might be very hard and costly to annually assign the right value to each relevant item of income for the purpose of tax assessment. Moreover, once a transaction is effected, the taxpayer materializes her investment and potentially receives funds to pay the appropriate tax on it; however, this may not be the case in a reorganization transaction where the taxpayer has not yet cashed out. This latter (liquidity) argument is really two-pronged: first, the taxpayer should have enough funds to physically pay the tax; and, second, it is possible to argue that she must be able to pay the tax from the *same* income on which it is levied. This latter rationale, based on fairness intuitions, obviously ignores the fungible characteristics of money, but may be strong politically since it allows a taxpayer to feel safe that she does not have to "bring money from home" in order to pay taxes on transactions in which she engages. These intuitions follow the *transaction tax* features of the income tax system. The schizophrenia of the system allows the reorganization provisions to be presented as fair even though in reality they represent a benefit granted discriminately to the more affluent.[24]

It is useful for my purposes to compare the realization-based income tax with a pure mark-to-market tax system, under which

24. *See, e.g.*, Greg Ip, *Boom, Bust Felt Mainly by the Rich*, WALL ST. J., Jan. 23, 2003, at D2.

personal wealth would be valued and taxed annually,[25] since the reorganization preferences represent a (favorable) exemption from the general rule of realization and the mark-to-market system represents a less favorable alternative regime than baseline realization itself. This comparison should put into context the extent of beneficial treatment embedded in the reorganization provisions. A mark-to-market system would be hard to implement. Although valuation methods have improved significantly, they are still quite inaccurate when it comes to some assets. Moreover, the values of some assets are traditionally subject to significant volatility, which adds to the inaccuracy of the process and to its relatively large exposure to abuse by taxpayers. A realization-based system, on the other hand, partially[26] avoids the need and costs of valuation, since it uses the transaction's market price. A pure mark-to-market system may require a taxpayer who holds an appreciated asset to pay tax on it before she has sold the asset, which may force her to sell the item in order to have the cash to pay the tax. This last scenario arguably shows the distortive potential effects of an income tax system that is not based on realization, since the latter is closer to a cash-flow tax. It does not require a taxpayer to pay tax before she actually realizes her wealth. Appreciation of assets, under this logic, is only potential income, and it materializes only when the taxpayer cashes in her investment (sells the asset). It is apparent, therefore, that the deferral benefit of nonrecognition for reorganizations is an excessive benefit, in addition to the deferral benefit inherent in a realization-based system, if we take a mark-to-market system as the baseline for the analysis.

Rich literature analyzing potential alternatives to the realization-based income tax system exists,[27] followed by recent prorealization literature countering such analysis.[28] The success of the critical

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25. This system would be the direct result of the elimination of the realization requirement from the current system.

26. The valuation problem is not completely avoided since many transactions involve related parties, thus forcing even a realization-based system to use some valuation trickery to ensure the use of the "right" price.

27. *See, e.g.*, David Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

28. Edward Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861 (concluding that, choosing de novo, we should elect realization rather than accretionism as a fundamental premise upon which to construct an income tax, since its virtues are attainable and the appeal of accretionism is theoretical and proved wrong when applied in the past; further arguing that accretionism can

literature has been, at most, limited to application of accretion-based assessment provisions to specific items of income, either mandatory or by election. It is reasonable to assume that this evolutionary process will persist, but that complete replacement of the realization-based system is unlikely. For the purposes of this Article this assumption suffices.[29] The messiness of the tax system, comprised of a hodgepodge of provisions that affect the timing of taxation of certain income in various ways, all of which deviate from the baseline of realization but not in any apparently consistent or coherent way, is exposed. These provisions apply to the same income items, but they sometimes cancel each other out, partially or completely, without sufficient justification. If we concentrate on the deferral benefit of the realization concept, we acknowledge a general preference that the tax system provides to investment and savings. Certain types of investments, mainly in the financial area, are explicitly denied this preference,[30] while other, not substantially different, transactions are granted an increased preference, since they are able to elect between realization and mark-to-market regimes.[31] From this perspective, the signals of the system are hard to decipher. It gets even worse: other types of nonrecognition transactions, including reorganizations, receive increased (deferral) preference.[32] With respect to these transactions, the code signals dissatisfaction with the technical rules of realization by stating that these transactions should not be taxed even though realization has occurred. The inference is that the realization in these transactions is not strong enough. Instead of modifying the standard for realization, the code has constructed another (similar) layer called "recognition." Normally, recognition

be applied, at most, sectorally and never universally, as realization can be applied). Schizer argues that realization is a subsidy for private savings and investments, assuming that such a subsidy is desirable. He concludes that, because it is credible, realization has a significant advantage as a subsidy despite its disadvantages—mainly inefficiency. He adds that a pivotal reason for its stability is that it doubles as a rule of administrative convenience. Schizer, *supra* note 23, at 1601.

29. I do not intend to evaluate or criticize the possible alternatives to a realization-based income tax system, as it has been ably done on several other occasions. I focus only on those aspects that relate to reorganization transactions.

30. I.R.C. § 475 (2000) (mark-to-market accounting method for dealers in securities); *id.* § 817 (treatment of variable contracts); *id.* § 1256 (marking to market certain contracts).

31. *Id.* § 460 (long-term contracts); *id.* § 475; I.R.C. § 1092 (straddle rules); *id.* § 1291 (passive foreign investment companies).

32. *See, e.g.*, *id.* §§ 354, 361, 1031.

follows realization automatically,[33] but in certain cases it does not, further extending the deferral preference. This extension is particularly extravagant with respect to corporate reorganizations.[34] After demonstrating the extraordinarily beneficial treatment of reorganizations in a system lacking satisfactory coherence, I present the stated argument for this preference, followed by its evaluation.

B. The Argument that Reorganizations Do Not Trigger "Sufficient" Realization

Shareholders in target corporations who exchange their shares for something materially different from those shares experience a realization event.[35] All of the basic transactions would trigger realization and recognition of gains under Section 1001(c) if it were not for the reorganization provisions. The rationale for the provisions is that even though *technical* realization may happen, i.e., shares or assets of one corporation are exchanged for shares in another corporation, that realization did not happen *substantively* since the value in the hands of the exchanging shareholders did not change. Moreover, the same business continues, and the same shareholders continue to own it, though now maybe through the gossamer veil of a paper we call a corporation. The technique used to implement this justice of not taxing shareholders undergoing reorganization without frustrating the integrity of the realization definition is to not recognize the income arising from the transaction. It is easy to see, nevertheless, that the changes effected in reorganizations are material. For example, look at the stock-for-stock, type B reorganization. It cannot be true that the exchanging

33. *Id.* § 1001(c).

34. In order to fully understand the effect of the special tax preference to reorganizations, we must start with an understanding of the tax effects of the corporate tax subsystem. This is yet another mess of mixed signals of incentives and disincentives in relation to a baseline of the Schanz-Haig-Simons definition of income. In this Article, I take the reasonable assumption that the United States has, and will continue to have, a classical corporate tax system. The basic effects of such a system are another level of taxation of investments in corporate capital on one hand (the corporate tax) and a convenient deferral opportunity on the other. Careful planning may allow not only the deferral of taxation of these proceeds, but also its avoidance. The reorganization provisions magnify this deferral preference, extending it beyond standard realization-capped periods.

35. This is true for shareholders of a target corporation in a merger, a stock-for-stock transaction, and an assets-for-stock transaction. In the latter case, the shareholders in the target corporation end up with stock from the acquiring corporation, which, in turn, acquires substantially all the assets of the target corporation, which disappears in the process.

shareholders of the target corporation get an equivalent investment, as they have diversified their investment by combining their business with another business. The case of T and her exchange of InventCorp stock for IBM stock in the merger is no different. If the result is otherwise, the transaction should not have been entered into in the first place.[36]

C. Analysis of the Realization-based Rationale for Reorganizations

Evaluation of the current reorganization provisions in light of the realization-based justification is problematic because realization itself is an elusive and sometimes vague (and even indefensible) concept. Some observations can, nevertheless, be made.

1. Valuation hardships

The concern over valuation does not support the extension of the realization preference to the case of reorganizations. Since any reorganization technically triggers realization, there is a visible market price used in the underlying transaction that can be properly used to determine the gains or losses realized. At least in the context of unrelated parties, this is one point in time when an arms-length price may be established and monitored by methods already employed by the code with respect to taxable acquisitions.[37] In the related parties context, the extraction of an arms-length price may be more difficult, but, again, we have specific provisions in the code to deal with such situations.[38] It may be argued that as we postpone the taxing event we may be in a better position to accurately evaluate the future market value,[39] but in the case of corporations with long horizons this argument is less convincing. The taxpayer sees only the price that she could currently realize in cash terms.[40]

As market prices are readily available, publicly traded stocks and securities pose no valuation problem. A theoretical valuation

36. I obviously ignore purely tax-motivated reorganizations here.

37. I.R.C. §§ 1001, 1060.

38. *Id.* § 482; Treas. Reg. § 1.482 (as amended in 2003). These provisions do require some special valuation and enforcement costs; the tax authorities must understand the scope of the transactions, so they may need to inquire into the whole set of relationships between the parties to the transaction.

39. This is because the future market value is the present value of future inputs.

40. It is possible to argue that this price may not be well-reflected in the transaction documents.

problem may arise, therefore, only when purely nonpublicly traded securities are exchanged.[41] These cases should be relatively few in number in comparison with exchanges in reorganizations that involve publicly traded stock. Nevertheless, in most transactions it does not seem to be very problematic to implement some basic rules that will preserve the integrity of any valuation method allowed, following accepted methods already found in other sections of the code. First, the parties to the transaction must file reports that are consistent with each other. Second, certain indicia must be reported, such as information about prior private financing. Finally, if the taxpayer fails to satisfy the authorities, then the taxpayer will bear the costs of a valuation audit. These provisions should ameliorate the possible problems of valuation in the rare cases where it is not simple to figure out.

Another possible problem may be the valuation of different business assets exchanged in stock-for-assets transactions. This difficulty and possible innovative solutions have been ably discussed elsewhere.[42] For the purposes of this Article, it is sufficient to say that even without major changes the code and regulations already provide specific rules sufficient to regulate this issue should the reorganization provisions be repealed.[43]

2. Liquidity concerns

Liquidity concerns may be more relevant to reorganizations than the valuation concerns. The reorganization tax preference is exclusive to transactions that use the stock of the acquiring corporation to compensate the target shareholders for their shares of the target corporation.[44] A target shareholder does not get any preference for

41. Even in these cases there are several ways to value the stock. *See* Shakow, *supra* note 27, at 1133–34 (reviewing some of these methods). Shakow, nevertheless, concludes that these alternative methods are probably not very effective and prefers an ambitious revolution of the tax system—elimination of the corporate tax or integration of the corporate tax with a tax on corporate distributions. *Id.* at 1136–37. I prefer to limit this Article to a less ambitious scope. I would put the valuation onus on the taxpayers. In most cases of unrelated parties, the market should be able to guard the right price, as in the current I.R.C. § 1060 provisions.

42. Shakow, *supra* note 27, at 1154–67.

43. I.R.C. §§ 338, 1060; Treas. Reg. § 1.338 (as amended in 2003); *id.* § 1.1060 (as amended in 2003).

44. Note that this is the case in all three relevant reorganizations—types A, B, and C. In a merger and in a stock-for-stock reorganization, it is straightforward. In an assets-for-stock reorganization, it is practically the same because the target corporation selling its assets is required to be liquidated.

cash received in the reorganization. Stock financing is a legitimate, and sometimes reasonable, form of financing an M&A transaction. But in many cases, the tax preference itself provides the strong incentive to use stock rather than cash transactions, no matter what method of financing is preferable pretax. In these cases, the liquidity concern can be quite contrived and has no place in a serious policy analysis. It is undesirable, therefore, to base a rule on taxpayers' motivations here, so in order to dismiss this argument I must determine whether the liquidity concerns are serious in the nontax-driven cases.

Liquidity concerns are nonexistent in cases of publicly traded stock and securities received by the target corporation's shareholders.[45] In the case of transactions involving private corporations, a more careful look is appropriate, since private corporations potentially include small businesses and shareholders with possible real cash-flow concerns. From the perspective of the main benefactors of the preferential tax treatment of the reorganization provisions (the target shareholders),[46] the only relevant case is the one in which nonpublicly traded stock and securities are exchanged for similar properties. The exchange of publicly traded stock and securities for nonpublicly traded stock and securities is possible, but unique. This latter situation signals financial strength on the side of the taxpayers receiving stock and therefore presents no real liquidity concerns. However, even the pure exchange of nonpublicly traded stock and securities is likely to involve mainly the wealthiest taxpayers in society.[47] The problem, therefore, cannot be technical inaccessibility to cash. Even if it were, it could be solved by postponing payment of the tax and adding

45. Shakow, in his proposal to replace the realization-based system with a mostly accrual system, has already discussed this. He emphasized that corporate equities account for 10.5% of all assets held by individuals, out of which almost 85% were publicly traded stocks. *See* Shakow, *supra* note 27, at 1132–33. This portion should be even more substantial when reorganizations are involved.

46. The other prima facie "benefactor" of the nonrecognition of the realization event is the acquiring corporation. This is, nevertheless, an issue unrelated to reorganization since § 1032, which I do not address in this Article, provides for nonrecognition to any corporation issuing stock for other property, whether a reorganization is effected or not. For further discussion, see *infra* Part IV.

47. Exceptional cases may involve amalgamations of small businesses and employee-owned corporations.

some interest charge.[48] This solution can also be used where it is determined that real liquidity concerns exist in transactions involving private corporations.[49]

A somewhat related argument may be that taxpayers perceive it as unfair to levy a tax prior to their cashing out. This perception may be problematic only if it represents a real liquidity problem. The perception itself may have some political bearing but should not concern us in this normative analysis.[50]

3. Realization as a credible subsidy to savings

Professor Schizer argues that realization may be a desirable subsidy to private savings and investment because of its credibility.[51] In the context of reorganizations, there is no doubt that it acts as a very credible subsidy to certain investments in corporations. The question is whether it is a desirable or an effective subsidy. The answer in the case of reorganizations is different from Schizer's positive answer with respect to realization in general, since reorganizations are an exception to the regular realization rule. They

48. This technical solution resembles in principle one of the more interesting alternatives to realization-based taxation—retrospective taxation plus interest charge. An advantage of this solution is that it mitigates the liquidity concern without introducing new significant distortions to the market for corporate control. For a discussion of this possible solution, see Shakow, *supra* note 27, at 1176, in the context of his proposal to switch to an accrual tax system. *See also* Cynthia Blum, *New Role for the Treasury: Charging Interest on Tax Deferral Loans*, 25 HARV. J. ON LEGIS. 1 (1988). For criticism, see Schizer, *supra* note 23.

49. It is a bad idea to apply different treatment to public and private corporations. *See* Bank, *supra* note 12, at 42–43.

50. Only real liquidity concerns justify realization-based rationales. Another fairness argument raised in connection with the liquidity argument is that taxing M&A transactions is too oppressive on a small corporate shareholder who did not necessarily support the transaction and now must sell her stock in order to pay the tax. Crockett suggests that this problem, if it arises, be solved in the same way the code treats other involuntary transactions. Ulysses S. Crockett, Jr., *Federal Taxation of Corporate Unifications: A Review of Legislative Policy*, 15 DUQ. L. REV. 1 (1976). Crockett refers to § 1033, which provides nonrecognition to taxpayers who suffer compulsory or involuntary conversion of their property if they replace it, within a specified period, with similar property. *Id.* at 19 n.112. I do not think such a solution is necessary from a fairness perspective, since such a taxpayer had to take this possibility into account ex ante. Such a taxpayer does not necessarily have a liquidity problem. I am not convinced by this fairness argument, but I do understand that it might be raised as part of the political legislative process. Crockett's solution, therefore, may be useful in this context, if required. It is not as harmful if applied only to true minority shareholders, since they do not drive M&A transactions; therefore, the distorted effects would, at most, be minor.

51. Its credibility is evidenced by its stability as a fundamental concept in the tax system throughout so many years, and the unlikelihood of any change in that stability. Schizer, *supra* note 23.

benefit a more exclusive and richer taxpayer group. Furthermore, I show in Part III that the reorganization provisions are not, in actuality, an effective subsidy to investments, since desired M&A transactions take place notwithstanding their existence. The fact that realization doubles as a rule of administrative convenience supports its stability and possible desirability. The same is not true with respect to the desirability of the reorganization preferences because of their complexity, significant evasion opportunity, and significant costs of their enforcement. Schizer himself mentions several disadvantages of realization as a subsidy—disadvantages that weigh even more against reorganization preferences.[52]

D. Realization and Perceptions of Fairness

Some argue that it is politically unrealistic to repeal the realization requirement.[53] The reason for this reality is that there are basic irrational fairness perceptions among taxpayers.[54] Professor Zelinsky argues that "[s]ince realization-based taxation is instinctively correct to many, if not most, taxpayers, [it] enhances both democratic values and taxpayer compliance."[55] He backs this argument with behavioral psychology theories of framing effects.[56] This should not affect my analysis and proposal, since there is no parallel between the perceptions of realization and the perceptions of reorganization preferences, which represent an exception to realization. The effect of these reorganization preferences is, simply put, the deferral of taxation of some investors in corporations. Much of that is due to the notorious wasteful complexity and exclusive planning opportunities reorganization preferences introduce to the system. It would be preposterous to argue that reorganization

52. The disadvantages are as follows: (1) less than optimal allocation of resources (as I analyze in Part IV); (2) the fact that effectiveness varies with the capital gains rate; (3) the fact that it is less credible than an upfront subsidy, possibly ineffective, and counterproductive (as I analyze in Part IV); and (4) the fact that realization favors "growth" stock over debt and "income" stock (this is particularly severe in reorganizations). Taxation will not solve the debt-equity distortion but will ameliorate it and eliminate the distortion to "income" stock. Additionally, it does not address a specific market failure that justifies intervention—that there is not enough savings, mainly because the government taxes income rather than consumption and runs a budget deficit. Schizer, *supra* note 23, at 1609–10, 1612, 1617–18, 1621–22.

53. Shaviro, *supra* note 19.

54. Zelinsky, *supra* note 28, at 893–900.

55. *Id.* at 893.

56. *Id.* at 898–900.

preferences enhance democratic values and compliance, since they represent the exact opposite: inequality in treatment of interchangeable types of investments and the epitome of tax planning.

III. EFFICIENCY JUSTIFICATIONS FOR TAX-FREE REORGANIZATIONS

Efficiency has not been explicitly stated in the legislative history as a justification for the enactment, or preservation, of the reorganization provisions. The legislative history took for granted that the reorganization provisions allow businesses flexibility and promote efficient transactions. This "intuition" was present in all the relevant debates but never directly studied or discussed.[57] Reading between the lines, however, proves that this "intuition" materially contributed to the stability of the reorganization provisions.[58] They continued to evolve and develop, endogenously, without any rethinking or evaluation of their actual consequences.[59]

In this section I challenge the validity of this assumption—that the reorganization provisions encourage efficiency—as a justification for their continuance. For this purpose, I depend on the extensive empirical and other economic, business, and corporate law M&A literature of the past two decades. The standard analysis of takeovers is based on the fact that internal growth is difficult, especially when it is needed to cover, or recover from, corporate underperformance. Therefore, corporations direct their growth efforts to the market for corporate control—a more flexible market than the product market. In some cases, some industries' needs for an overhaul restructuring (since they face deregulation, for instance) triggered or reinforced their redirection to the market for corporate control. Nevertheless, this simple picture has proven more complicated at second glance.

57. It has not been seriously studied even by academics. Professor Lovett argued that mergers should meet a market test for efficiency, but he has not comprehensively detected the actual efficiency consequences of mergers. It should be noted that he did not have the rich empirical data we have today. Lovett, *supra* note 9, at 853. Professor Shaviro briefly discussed reorganizations in his analysis of the efficiency benefits of realization, accepting the choice of Congress in this area; however, he pointed to the same problems on which I elaborate here. Nevertheless, if we take his major points, we can see that the reorganization rules do not fare well. This is not surprising, since they are an unjustified exception to the poteutially efficient realization rules. Of course, most of the data presented in this Article was not available to Professor Shaviro at the time he wrote his article—pre-1992. *See* Shaviro, *supra* note 19.

58. *See, e.g.*, Hellerstein, *supra* note 9.

59. As did all of Subchapter C of the IRC. *See* Clark, *supra* note 16, at 92-93 (from whom I borrowed the above morphogenetic metaphor).

Recent study shows that multiple factors affect M&A activity and motivations. Moreover, these factors are dynamic—they change as market circumstances change, making the analysis even more difficult since the perspective of time may be needed to even identify these factors. Nevertheless, certain patterns can be identified, allowing me to reach the conclusion that the reorganization provisions cannot be *a priori* justified on efficiency grounds since they represent a group of transactions that is not identifiably more desirable than other M&A transactions. In fact, it may be less desirable. I also show that the reorganization rules do not play a decisive role even in the initiation of the transactions they are supposed to encourage, which makes them ineffective and wasteful even with respect to those transactions. I start this section with background that should provide some common ground for the discussion, followed by a reconstruction of the possible efficiency arguments supporting the reorganization provisions and an analysis of their validity in light of the external literature.

A. Background

1. Taxation and neutrality

In order to effectively apply the wisdom of this external (nontax) literature to a tax discussion, I need to add some background notes on both the tax system and the external analysis of M&A transactions. I start with tax. It is a basic concept of tax law that its rules come into play only after the application of private law rules, primarily those of property and commercial law. For example, if I sell a picture that has appreciated in value since I bought it, I, as a taxpayer, should realize this increase in value (and recognize it) as a taxable gain, but this is true only if I were actually the owner of the picture and if the transaction I engaged in were actually a sale. This concept, although fundamental, is not cogent, since in certain cases the tax law deviates from private law consequences. Such deviation may be justified by anti-avoidance reasons,[60] as well as administrative

60. For example, a sale of certain intellectual property is not economically different from licensing it for a long (enough) term; but the tax consequences may be significantly different, especially at the international level where a withholding tax is imposed on royalty payments but not on sale proceeds. For this reason, taxpayers have tried to disguise licenses as sales contingent upon performance, profits, etc. One legislative answer has been § 881(a)(4), which taxes gains "flavored" with royalty features similar to royalties.

convenience and political reasons. Any deviation must have a good reason, since it represents the exception rather than the rule.

A fundamental tax policy concept that follows is the requirement that tax laws be neutral; they should perform their task of taxation without affecting, i.e., distorting, the business and investment decisions of taxpayers. Neutrality is a central characteristic of an efficient tax system,[61] which performs its task to provide governments with funds they can use to finance public goods for their constituents. However, in our second-best world, no tax system can be completely neutral.[62] Corporate taxation is, by definition, not neutral, since it taxes legal persons who do not bear the actual incidence of the tax. At the very basic level, the corporate tax provides a disincentive to invest and do business through corporations.[63] The reorganization provisions are also not neutral.[64] They provide an opposite incentive—to operate through corporations, since they represent a benefit that can only be enjoyed if one does just that. The benefit is, as already mentioned, tax-deferral treatment of certain transactions using (primarily)[65] stock as consideration, and only to the extent of that stock consideration.

61. Neutrality and efficiency are not synonymous; nevertheless, since the tax system operates in an imperfect market, a nonneutral tax system may still be efficient, provided that it "corrects" market failures. This distinction is, however, mainly theoretical, since the whole analysis is effectively in a second-best world.

62. Lump-sum taxes are basically neutral but politically impossible, as proved by the classic example of the Thatcher Administration's attempts to implement them in the United Kingdom in 1990. For a good review, see HARVEY ROSEN, PUBLIC FINANCE 282–87 (6th ed. 2002).

63. This is not so simple, though, since different provisions of Subchapter C provide contradicting incentives. *See* Clark, *supra* note 16.

64. The corporate tax itself underlies this issue since it distorts incentives to do business and investments through corporate entities versus other entities, but this problem is beyond my scope. I assume here that the corporate tax is here to stay, and I will take it, therefore, as a given. Further, I do not intend here to evaluate whether the reorganization provisions should be neutral, whether they are neutral enough, or other similar questions, which will be partly discussed below. For the effect of the reorganization provisions on M&A transactions, see James W. Wansley et al., *Abnormal Returns to Acquired Firms by Type of Acquisition and Method of Payment*, FIN. MGMT., Autumn 1983, at 16, 16–22 (observing significantly higher returns to target shareholders compensated mainly with cash, in comparison to those compensated mainly with stock, and concluding that these should be attributed to the tax effect). For a more detailed analysis, see Carla Hayn, *Tax Attributes as Determinants of Shareholder Gains in Corporate Acquisitions*, 23 J. FIN. ECON. 121 (1989).

65. Current rules allow mergers to qualify as reorganizations if at least 40% of the consideration is in any type of stock. They demand 100% voting stock consideration in type "B" (stock-for-stock) reorganizations, and at least 80% voting stock consideration in type "C" (assets-for-stock) reorganizations. I.R.C. § 368(a)–(c) (2000).

Simply put, the parameters most relevant in tax law to attain this benefit are that the transactions have primarily stock consideration, the benefit is given only to stock consideration, the transactions are founded on appropriate motives (only business reasons qualify as such), a significant part of the former shareholders maintains equity risk in the surviving entity, and a significant continuity of the old business, or its assets, is maintained. The deviation of these rules from neutrality should, therefore, have a convincing reason. I claim in this Article that the reorganization law does not have any reason in general, and in this section I demonstrate that it could not be justified by efficiency in particular.

2. The basic concerns of the external literature

The external literature[66] is more concerned with different features of M&A transactions than with the tax rules. It focuses on regulation, competition, and corporate governance. Therefore it primarily studies market power, efficiency, and internal agency problems. The most significant mutually relevant parameter between this literature and the concerns of tax law is the type of consideration used in the transaction. Other important issues studied by this literature are the phenomenon of M&A "waves," defined by the increase in both number and volume of such transactions in modern times, the hostile features of the transaction, and the classification of vertical, horizontal, and conglomerate transactions.[67] The purpose of these studies is to better understand why corporations enter into M&A transactions and the social consequences of these transactions. They result in a weak understanding that M&A transactions are socially beneficial on average, i.e., they create wealth instead of just redistributing it from one sector to another. This, however, does not fully explain the continuing motivations of corporations to enter this risky and extremely costly game. These motivations may vary and are not very clear or simple.

It is common to divide M&A transactions into waves. The first M&A wave peaked at the turn of the century, creating, in predominantly horizontal combinations, some of the largest

66. For example, the economic, business, and corporate law literature.

67. In a vertical merger, the transaction is between entities that have a buyer-seller relationship. In a horizonral merger, the transaction is between competitors, and in a conglomerate merger it is between firms in unrelated businesses (i.e., they are not competitors and do not have a buyer-seller relationship of any kind).

monopolies of our time.[68] The second wave, lasting from 1916 to 1929, practically continued this pattern, but since the antitrust environment of the period was stricter, it consisted mainly of the consolidation of industries and resulted in oligopolistic rather than monopolistic structures.[69] The next wave was delayed until the second part of the 1960s. During the four interim decades, antitrust legislation continued to tighten, and M&A activity was concentrated in smaller firms and, many times, had tax rather than business motivations.[70] Asset acquisitions, in particular, thrived because they were not covered by the Clayton Act until 1950.[71] This changed with the third wave, which introduced big conglomerates taking advantage of a booming economy and favorable tax and accounting treatments through, among other tactics, the increased use of stock as compensation to target shareholders.[72] Today we know that conglomerates failed as a business model and reduced social wealth rather than increasing it.[73] The fourth wave, in the 1980s, was evidently the first to contribute to the efficiency of the market, introducing hostile takeovers to the business scene.[74] It took place in a decade of large economic expansion, including some noticeable international involvement for the first time. This wave was characterized by the increased use of debt to finance M&A transactions. Takeover specialists dominated both tactical and strategic aspects of the market. After a mild recession, the 1990s brought about its own M&A wave, which in many aspects combined

68. PATRICK GAUGHAN, MERGERS, ACQUISITIONS AND CORPORATE RESTRUCTURINGS 23 (3d ed. 2002).

69. *Id.* at 28.

70. *Id.* at 32.

71. The Cellar-Kefauver Act of 1950 closed this loophole. *See id.* at 33.

72. *Id.* at 32–37.

73. One explanation is that, currently, diversification at the corporate level is just too expensive. Nevertheless, ample evidence makes it doubtful that there is any desirability for conglomerate transactions. Henry Servaes, *The Value of Diversification During the Conglomerate Merger Wave*, 51 J. FIN. 1201 (1996) (stating conglomerates were valued at a discount, on average, during the 1960s third merger wave). Current literature on diversification in general provides interesting parallels in its findings that both industrial and global (geographical) diversifications are, on average, value-destroying. Lance A. Nail et al., *How Stock-swap Mergers Affect Shareholder (and Bondholder) Wealth: More Evidence of the Value of Corporate "Focus,"* 11 J. APPLIED CORP. FIN. 95 (1998) (using a sample of pure stock mergers from 1963–1996 and showing disappointing results to bondholders in conglomerates); *see* David J. Denis et al., Global Diversification, Industrial Diversification, and Firm Value (Aug. 2001), *available at* http://ssrn.com/abstracts=244721.

74. GAUGHAN, *supra* note 68, at 44.

the third and fourth waves (however, the first two waves were considered anticompetitive and therefore existed in a substantially different legal and business environment).[75] The typical fifth-wave M&A transaction was strategic (rather than financially opportunistic), increasingly using equity financing; it was less hostile than the transactions of the 1980s and much more international in scope.[76] In general, the typical fifth-wave M&A transaction seemed to be a more efficient, synergy-gains-driven M&A transaction.[77] The variety and constant evolution of these transactions may place in question our ability to correctly match tax rules that will correlate with the desirable features of M&A.

Another important part of the external literature focuses on the distinction (ignored by the tax analysis of reorganizations) between hostile and friendly transactions following the 1980s fourth wave of M&A ttansactions. Hostility in a takeover bid has been attacked as threatening shareholders and management, forcing them to implement wasteful defensive mechanisms,[78] and revered as the market mechanism to discipline and/or replace inefficient management.[79] In reality, it is not easy to identify such hostility and use it as a meaningful feature, since "most transactions contain elements of both friendly and hostile deals."[80] Moreover, recent evidence proves that hostility in takeover negotiations is most strongly related to strategic bargaining by the target and is significantly less related to management entrenchment.[81] Therefore,

75. As does most of the external literature I review, I basically ignore these two first waves.

76. GAUGHAN, *supra* note 68, at 51–54.

77. Caution is needed, however, since perspective and several other analytical tools may be required to comprehensively evaluate it.

78. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314 (John C. Coffee, Jr. et al. eds., 1988).

79. *Id.* The classical article promoting this basic story of takeovers and their benefits is Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

80. G. WILLIAM SCHWERT, HOSTILITY IN TAKEOVERS: IN THE EYES OF THE BEHOLDER? 1 (Nat'l Bureau of Econ. Research, Working Paper No. 7085, 1999), *available at* http://www.nber.org/papers/w7085.

81. *Id.* at 31–33. Interestingly, in spite of the dominance of the bargaining explanation to hostility, there is no strong and conclusive evidence on the superiority of hostility in terms of the premiums received, even though this inconclusiveness seems to be due to the hardship of defining and identifying hostility. *Id.* at 20–25. *See also* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271

the level of hostility changes over time and has no inherent distinguishable features.[82] Hostility in a transaction is thus just another way to maximize the consideration to the target shareholders. One conclusion that may be drawn from this analysis is that hostility should have no distinguishable direct tax consequences, since it does not change the nature of the transaction, it is vaguely defined, and it is very hard to identify and quantify. On the other hand, there is evidence that hostility may impact the efficiency of transactions. A set of studies of hostile and friendly transactions concluded that these are two completely different processes that target "very different companies and hence should not be treated as examples of the same economic process."[83] Shleifer and Summers added: "[I]t would be a serious conceptual mistake to use the data on friendly acquisitions to interpret theories of hostile takeovers."[84] From my perspective, we do expect hostility to result in different types of consideration, since we do not expect stock to be very attractive in a hostile context. This expectation is somewhat supported by the evidence.[85] Nevertheless, the low likelihood that only equity will be offered in a hostile context[86] makes it harder and costlier for such a transaction to qualify as a reorganization. Reorganizations that completely disallow "boot" (payment in a form other than the stock of the bidding corporation) are the costliest and most improbable.[87] In this Article I will not discuss this distinction

(2000) (confronting academia's attack on poison pills with evidence that defenses were used not for management entrenchment purposes but rather for bargaining purposes, supporting the bargaining explanation to hostility). Coates developed the notion that it is enough to know that a poison pill could be adopted anytime for its effect to be felt ("shadow pill"), and explained that share prices do not fall upon the actual adoption of the pill. Rather, prices already have adjusted to the "shadow pill." His article emphasizes two major problems in the research of M&A transactions: (1) the never-ending methodological debate, which casts doubt on the usefulness of any study in the field; and (2) the multiplicity of relevant factors that makes the research so complex.

82. In fact, in the 1990s, takeovers tended to be less hostile. Joseph H. Flom, *Mergers and Acquisitions: The Decade in Review*, 54 U. MIAMI L. REV. 753, 761–62 (2000).

83. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 48 (Alan J. Auerbach ed., 1988); *see also* Randall Morck et al., *Characteristics of Hostile and Friendly Takeover Targets*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101 (Alan J. Auerbach ed., 1988); Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7 (1988).

84. Shleifer & Summers, *supra* note 83, at 48.

85. SCHWERT, *supra* note 80, at 8.

86. *Id.*

87. That is the type B, stock-for-stock, reorganization. I.R.C. § 368(a)(1)(B) (2000).

separately but as part of the general discussion of the important distinction between cash and stock transactions.

Another important distinction that has no tax consequences is the distinction between vertical, horizontal, and conglomerate transactions. The tax law requires "a" business purpose, but is basically silent as to the type of business purpose required.[88] Even the continuity-of-business requirement does not necessarily mandate that the target's business will be continued, since it suffices that the old business's assets are used in "a" business.[89] One could expect different motivations for conglomerate and nonconglomerate transactions. The evidence has proven this idea to be true, presenting different efficiency benefits to these two categories of M&A transactions, which transactions are still ignored by tax law. This point may be moot in light of the current unpopularity of conglomerate transactions.

3. Neutralizing the effect of taxation on current studies

Finally, I attempt to normatively evaluate the tax rules applying to M&A transactions as if they had occurred in a completely neutral, unrealistic tax world. In the real world examined by the external literature, taxation affects M&A transactions in two ways: first, corporations engage in transactions because there are tax attributes (potential benefits) that may be better utilized by the combined corporation (tax synergy); and second, corporations engage in transactions because there are tax benefits to shareholders, i.e., tax deferral in certain transactions and circumstances through the reorganization provisions. It is important to distinguish between the two. In this Article, I only examine and question the justification for the latter. The former plays a role in the motivation system for M&A transactions. I will refer to it and explain it together with the other factors, although I can say that its role is not entirely clear to me at the present.[90] The external literature assumes the tax regime of its

88. BITTKER & EUSTICE, *supra* note 8, ¶ 12.61[1].

89. Treas. Reg. § 1.368-1(d)(1) (as amended in 2001).

90. Hayn, *supra* note 64, at 148 (providing evidence that tax attributes of the target are significant in explaining the abnormal returns to the target's shareholders, and suggesting that tax considerations do motivate acquisitions, i.e., successful "reorganization" increases the likelihood of completion of the transaction). Note that some of the studies in this field took place prior to the Tax Reform Act of 1986 and the repeal of the *General Utilities* doctrine when additional distortions between taxable transactions and reorganizations existed.

time, including the reorganization provisions, as a given, and since my goal here is to normatively evaluate these, I try to neutralize their effect.

B. Are M&A Transactions Efficient?

The first prong of an efficiency justification for reorganizations must be that M&A transactions are generally wealth-creating,[91] socially desirable transactions in and of themselves.[92] For my purposes, this is only the first step, since the reorganization provisions apply to (and benefit) only stock transactions. If we isolate stock transactions from the general M&A population, most (or all) of the social value of these transactions disappears.[93] The results are

91. The bulk of the available studies show that M&A transactions are, in general, wealth creating. Jensen, *supra* note 78; Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 124 n.13 (1992); MICHAEL C. JENSEN & DONALD H. CHEW, U.S. CORPORATE GOVERNANCE: LESSONS FROM THE 1980S, at 6–7 (Harvard Bus. Sch., Negotiation, Organizations and Markets, Research Paper No. 00-02, 1995). Current European studies show similar results to U.S. studies. *See* M. Goergen & L. Renneboog, Shareholder Wealth Effects in Large European Takeover Bids (Feb. 4, 2002) (unpublished manuscript, on file with author). Results in the United Kingdom are also similar to U.S. results. S. GIRMA ET AL., MERGER ACTIVITY AND EXECUTIVE PAY (Ctr. for Econ. Policy Research, Discussion Paper No. 3255, 2002) (concentrating on executive pay and finding that shareholders had relative success in penalizing management engaged in mergers that did not create wealth to shareholders and were motivated by management interests). In Germany the market was just recently created as a result of deregulation. MARTIN HOPNER & GREGORY JACKSON, AN EMERGING MARKET FOR CORPORATE CONTROL? THE MANNESMANN TAKEOVER AND GERMAN CORPORATE GOVERNANCE (Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper 01/4, 2001) (describing this process and concluding that, currently, efficiency effects of the process are questionable). A 1999 survey conducted by KPMG revealed that 83% "of mergers were unsuccessful in producing any business benefit as regards shareholder value." *Unlocking Shareholder Value: The Keys to Success* (KPMG, London, U.K.), Nov. 1999, at 2, http://www.kpmg.com/Rut2000_prod/Documents/9/MA%202001.pdf. KPMG's 2001 survey found this figure to be 70%. *World Class Transactions* (KPMG, London, U.K.), 2001, at 5, http://www.kpmg.com/Rut2000_prod/Documents/9/KPMG_MA_2001_web_new.pdf.

92. Of course, it is theoretically possible that although M&A transactions are inefficient pre-tax, the imposition of tax will make them efficient, but this construction is completely unreasonable in my context so I ignore it.

93. The specific motivations that drive these transactions may be irrelevant to this discussion, even if they result in wealth transfers between sectors of society (mainly shareholders to managers). Romano, *supra* note 91, at 124 n.15. This is, nevertheless, debatable since one may argue that although motivations as such are not important to tax policy determinations, redistribution effects are, especially when significant dollar amounts are involved. Jensen, *supra* note 78, at 315–16 (referring to an estimation by Paulus that target shareholders shared approximately $75 billion of $239 billion worth of M&A transactions in 1984 and 1985). For the purposes of this Article, I ignore the effects of redistribution, since it is unclear how significant these effects are and, in any case, these effects cannot support the

worse for conglomerate transactions.[94] These results are problematic to the efficiency-based justification of the reorganization provisions, since they supposedly encourage the less-efficient type of M&A transactions. Next, I elaborate on the efficiency properties of stock transactions (standing alone) in comparison with cash transactions, and conclude that they are not more desirable than cash transactions on efficiency grounds.

1. The importance of the method of payment

The vast literature demonstrates that the method of payment plays a significant role in M&A transactions and affects their consequences. The extent, and sometimes even the existence, of the effects of the method of payments are not always clear. It is clear, however, that this literature cannot support a claim that stock transactions are superior to cash transactions.[95]

M&A transactions result in a puzzling variety of consequences to the participants. Probably the least intuitive consequence is the relatively small returns to the acquiring corporation's shareholders in comparison with the target shareholders. These returns are particularly small (and even nonexistent or negative according to some studies) in transactions using stock to compensate the target corporation or its shareholders.[96] With respect to the transactions as a whole, these studies have been fairly consistent in finding that cash M&A transactions generate value to shareholders on both sides of the transaction, and are, on average, both economically and statistically efficient. Stock transactions, on the other hand, have consistently been inferior to cash transactions. However, on average, they are still believed to create value to shareholders as a general group, although the acquiring corporation's shareholders do not

current tax regime, but rather add a fairness criticism to my other criticisms of this regime (assuming, very simply, that managers are, on average (no matter how one calculates it) much more wealthy than shareholders).

94. As the costs of diversification to individuals decrease and capital markets expand and become more easily and cheaply accessible, it is less attractive to investors to use corporations to sufficiently diversify their portfolio. This way they avoid the nominal and agency costs and other inefficiencies involved with doing it through (particularly) the conglomerate structure.

95. *See, e.g.*, studies mentioned *infra* note 97.

96. For a review of these studies, see Kenneth J. Martin, *The Method of Payment in Corporate Acquisitions, Investment Opportunities, and Management Ownership*, 51 J. FIN. 1227, 1227–28 (1996).

reap the bulk of this benefit.[97] Stock transactions, therefore, have been found to be generally inferior, or at least not superior, to cash transactions from the perspective of wealth creation. The inferiority of stock transactions is evident not only in studies of announcement-period returns, but also in studies of postacquisition returns and poor operating performance after the transaction.[98] Studies of transaction forms found similar results that demonstrated the superiority of tender offers over mergers. These results are logical since seldom will tender offers use stock, though it is becoming

97. *See, e.g.*, Jensen, *supra* note 78, at 335–36; James W. Wansley et al., *Gains to Bidder Firms in Cash and Securities Transactions*, 22 FIN. REV. 403 (1987); *see also* B. Espen Eckbo & Herwig Langohr, *Information Disclosure, Method of Payment, and Takeover Premiums*, 24 J. FIN. ECON. 363 (1989) (showing that, in France, abnormal returns to target shareholders are related to the form of payment); B. Espen Eckbo et al., *Asymmetric Information and the Medium of Exchange in Takeovers: Theory and Tests*, 3 REV. FIN. STUD. 651 (1990) (similar results in Canada, including when checking mixes of cash and stock as compensation in takeovers); Julian R. Franks et al., *Means of Payment in Takeovers: Results for the United Kingdom and the United States*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 221 (Alan J. Auerbach ed., 1988) (same results in the United Kingdom); Robert G. Hansen, *A Theory for the Choice of Exchange Medium in Mergers and Acquisitions*, 60 J. BUS. 75 (1987); Yen-Sheng Huang & Ralph A. Walkling, *Target Abnormal Returns Associated with Acquisition Announcements*, 19 J. FIN. ECON. 329, 348 (1987) (same results in the United States); Nikolaos G. Travlos, *Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns*, 42 J. FIN. 943 (1987). For a recent study confirming these results see ERWAN MORELLEC, THE DYNAMICS OF MERGER AND ACQUISITIONS (Simon Sch. of Bus., Working Paper No. FR 01-11, 2002), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID281534_code010830590.pdf?abstractid=281534.

Other studies show consistent results, except they find negative total returns in stock transactions. *See, e.g.*, Servaes, *supra* note 73. *But see* Saeyoung Chang, *Takeovers of Privately Held Targets, Methods of Payment, and Bidder Returns*, 53 J. FIN. 773 (1998). Chang finds different results—positive abnormal returns in stock offers (and none in cash offers) when the target is privately held. However, a recent Australian study also sampling privately held targets finds different results from Chang consistent with the majority of studies of publicly traded targets mentioned above. RAYMOND DA SILVA ROSA ET AL., THE EQUITY WEALTH EFFECTS OF METHOD OF PAYMENT IN TAKEOVER BIDS FOR PRIVATELY HELD FIRMS (Univ. of W. Austl., Working Paper No. 2001-138, 2001), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID269212_code010510600.pdf?abstractid=269212.

98. Martin, *supra* note 96, at 1228; Nicholas F. Carline et al., The Influence of Managerial Ownership on the Real Gains in Corporate Mergers and Market Revaluation of Merger Partners: Empirical Evidence (Eur. Fin. Ass'n 2002 Berlin Meetings Discussion Paper, 2002) (presenting similar data on a recent U.K. sample, but not when excess cash is involved), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID302606_code020321600.pdf?abstractid=302606. Then it is consistent with Jensen's free cash flow theory, discussed *infra* note 148. *But see* Randall Heron & Erik Lie, *Operating Performance and the Method of Payment in Takeovers*, 37 J. FIN. & QUANTITATIVE ANALYSIS 137 (2002). They provide also a good summary of prior studies and demonstrate the methodological difficulties of constructing such a study. *Id.* at 137–39.

increasingly popular in mergers.[99] The narrow way to interpret these results is to say that, although weak, the efficiency-based explanation of the reorganization rules withstands these results since it is still possible that without reorganizations these (although relatively minor) efficiency benefits will be lost. Another possible interpretation is that the bias embedded in the reorganization rules in favor of the use of stock in M&A transactions is inefficient, since, if anything, it encourages the less efficient stock transactions and perhaps discourages the more efficient cash transactions. Moreover, studies to date do not separate transactions that benefit from the reorganization provisions from other taxable stock transactions. We do not know, therefore, if reorganizations are efficient in general. Such a conclusion cannot be deduced from the weak and disputable evidence that stock transactions are generally wealth-creating. Clear and direct evidence is not available, but its acquisition may be a worthwhile future project.

Why, then, is the use of stock increasingly popular in M&A transactions? There are many practical elements supporting the preference of stock payments. The first centers on funding concerns. A major obstacle to a cash transaction is obviously the need for cash,[100] which may be unavailable or very costly to raise quickly and in large volumes. Stock, on the other hand, has become a cheaper and more prevalent currency in the past decades. Another reason for the preference given to stock transactions is that managers like to pay with stock since it allows them increased flexibility in current and future investment opportunities.[101] The evidence shows a strong correlation between stock payments in M&A transactions and greater investment opportunities for the acquiring firm,[102] which, in

99. Michael J. Fishman, *Preemptive Bidding and the Role of the Medium of Exchange in Acquisitions*, 44 J. FIN. 41 (1989). Another distinction that is similar is the distinction between hostile and friendly transactions, since in the hostile setting the bidder is basically forced to use a tender offer and cash. These studies are related and their results correlate, so I do not devote separate discussions to them. See Huang & Walkling, *supra* note 97, at 348, with respect to the relations between cash transactions, hostile bids, and takeovers on one hand, and stock transactions, friendly bids, and mergers on the other hand.

100. J. Fanto, Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers (May 22, 2000), *available at* http://papers.ssrn.com/sol3/delivery.cfm/000421558.pdf?abstractid=223149.

101. Martin, *supra* note 96, at 1243.

102. *Id.* at 1228 (consistent with and referring to KOOYUL JUNG ET AL., INVESTMENT OPPORTUNITIES, MANAGERIAL DISCRETION, AND THE SECURITY ISSUE DECISION (Nat'l

contrast to most of the evidence presented in this Article, is not an undesirable aspect of stock transactions. Of course, it is hard to distinguish in this context between real opportunities and management opportunism, so the bottom line may not be positive regarding stock transactions after all. In other circumstances, cash transactions can be connected to management opportunism—the use of available cash for empire-building rather than for distribution to the shareholders.[103] Stock transactions may also be preferred from a public-relations perspective, since it may be easier to "sell" a merger as a "merger of equals" rather than as a cash transaction that will look more like a "sale" of one corporation to the other.[104] Target managers that also own stock in the target corporation like stock transactions because the managers are more likely to retain jobs in the surviving firm if they are also shareholders.[105]

These explanations are insufficient to fully account for the extent of the use of stock in M&A transactions, however. As demonstrated in the next section, mosr of the literature concentrates on the effects of both incentives and signals to the market that result from information asymmetry with respect to the true value of either the target or the acquiring corporation in the M&A context on decisions regarding the method of payment.[106] Hansen has developed the theory that the acquiring corporation has an incentive to pay the target with stock because if the acquiring corporation overpays for the target, target shareholders now holding shares in the acquiring corporation will share some of that risk.[107] Cash payments signal that the risk of overpayment is considered low or that the acquiring

Bureau of Econ. Research, Working Paper No. 4907, 1995), *available at* http://papers.nber.org/tmp/43608-w4907.pdf).

103. This is consistent with Jensen's free cash flow theory, discussed *infra* note 148.

104. *See infra* note 148.

105. *See* Aloke Ghosh & William Ruland, *Managerial Ownership, the Method of Payment for Acquisitions, and Executive Job Retention*, 53 J. FIN. 785, 797 (1998). This is consistent with Martin, *supra* note 96, at 1228, 1244. *See also* Yakov Amihud et al., *Corporate Control and the Choice of Investment Financing: The Case of Corporate Acquisitions*, 45 J. FIN. 603 (1990); René M. Stulz, *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25 (1988).

106. This is consistent with the general theory about asymmetric information and stock issuance. *See, e.g.*, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

107. Hansen, *supra* note 97.

corporation is assigning a high value to the target.[108] Another aspect of this theory is that high-value bidders, or bidders with private information that they are themselves undervalued, are more reluctant to use stock in an acquisition since they want to preserve the value potential of their stock for their own shareholders (assuming that there is an alignment of interests between management and shareholders).[109] Information about possible synergies that may result from the merger is also in effect factored into the share price and may affect the negotiation over the method of payment used. This theory reinforces my discomfort with the current reorganization rules. These rules benefit only transactions that supposedly provide a *bad* signal that the management of the acquiring corporation is predicting a risk that it may overpay for the target in the transaction. On the other hand, they do not benefit transactions that provide a *good* signal of prosperity and high cash flow in the acquiring corporation.[110]

Finally, of course, tax rules could be the reason for the use of stock in M&A transactions due to their preferential treatment of certain stock transactions. The importance of tax as a factor in M&A transactions deserves a separate section, which follows, since it is at the heart of my argument and takes the analysis a step forward. Nevertheless, to complete my analysis in this section, I note that tax treatment cannot explain the full difference in value creation between cash and stock transactions.[111] Tax does play a major role in a corporation's decision to use stock rather than cash in a transaction. However, tax treatment is not such a driving force behind the decision to actually enter into a transaction, although some transactions are tax-driven and lack any additional business-related purpose.[112]

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108. Fishman, *supra* note 99. Fishman shows that this signal (cash offer) is also effective in deterring other bidders from competing with an acquiring corporation that offers cash in a bid. *See also* THOMAS FIELDS & THOMAS LYS, OPTIMAL STRUCTURE OF THE CONSIDERATION IN MERGERS AND ACQUISITIONS (Working Paper, 2000), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID239723_code000919510.pdf?abstractid=239723). See Martin, *supra* note 96, for support of the asymmetric information theory.

109. This is true even when mixed payments are made. Eckbo and others found that higher-valued bidders are more likely to use more cash in M&A transactions. Eckbo et al., *supra* note 97.

110. Romano, *supra* note 91, at 123 n.11.

111. Franks et al., *supra* note 97. In the United Kingdom, prior to the introduction of the capital gains tax, similar results are evidenced. *Id.* at 221.

112. We expect these latter transactions to be generally inefficient.

In conclusion, I found no valid argument that supports the grant of tax benefits to stock transactions in particular.[113] The reorganization rules apply solely to stock transactions (and only to the stock portion of such transactions) out of a heterogeneous complex of M&A transactions. Awkwardly, despite the intricacy, variety, and evolving nature of M&A transactions, the literature is consistent that this "chosen" group is not superior to other M&A transactions from an efficiency perspective. Next, I demonstrate that from this perspective the reorganization rules are largely irrelevant even with respect to stock transactions.

2. Do tax rules drive M&A transactions?

From a business perspective, tax treatment has always been considered an important factor in the list of possible motives for M&A transactions. Although there is some evidence that tax benefits could affect primary decisions, such as whether to enter into an M&A transaction or not,[114] this evidence is not very significant.[115]

Tax benefits are significant, nevertheless, in the decision of how to execute an M&A transaction and particularly in the choice of

113. One unresolved situation is with respect to M&A transactions where stock is used due to lack of cash or the significant costs of using it.

114. Hayn, *supra* note 64, at 148. This study examined a legal situation, prior to the Tax Reform Act of 1986, which was very different from the present and allowed easier exploitation of reorganizations to achieve tax avoidance that is practically shut down at the present. *See also infra* Appendix. Additionally, a major finding of Hayn's was that successful "reorganization" increased the likelihood of completion of an M&A transaction. This finding may still be valid, but it does not make tax a primary explanation for the initiation of M&A transactions. *Id.*

115. Analysis of a comprehensive 1968–1983 sample found that tax reduction was not a significant motive for M&A transactions. Even when tax benefits had some value, it was far lower than the overall premiums. Alan J. Auerbach & David Reishus, *The Impact of Taxation on Mergers and Acquisitions*, *in* MERGERS AND ACQUISITIONS 69, 81 (1988); *see also* Martin D. Ginsburg, *Comment*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 366 (John C. Coffee, Jr. et al. eds., 1988). Romano further surveys later studies, none of which provide support for a general tax-driven explanation for M&A transactions. *See* Romano, *supra* note 91, at 135–36. Moreover, the same results could be achieved using alternative techniques that are not inferior to reorganization preferences. *See* Ronald J. Gilson et al., *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 271 (John C. Coffee, Jr. et al. eds., 1988). *But see* Elliott J. Weiss, *Comment*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 360 (John C. Coffee, Jr. et al. eds., 1988). Doubting the conclusiveness of the results of Gilson and others, Weiss argued that in the real world, it is not so easy to achieve the tax benefits that one may achieve in M&A transactions in alternative ways, even if it is possible theoretically. Weiss rightly limits the strength of the argument of Gilson and others, but not its validity. He also does not argue that tax benefits are substantially driving M&A transactions.

payment methods.[116] Once a decision to enter a specific transaction is made and the business fundamentals are agreed upon, the parties will try to minimize its tax implications. This typically leads to an attempt to qualify the transaction as a reorganization in order to take advantage of the tax deferral benefits of these rules.[117] This also means that stock rather than cash will be used for payments.[118] This observation, which is obvious to anyone involved in these transactions, is a very powerful criticism of the efficiency justification for reorganizations, since it exposes the fact that such transactions will be entered into with or without the tax subsidy that reorganizations represent.[119] The subsidy embedded in the reorganization provisions is therefore ineffective at best.

This is the next step in my analysis. It exposes the fact that even the narrow interpretation of the efficiency properties of stock transactions cannot support the preservation of the reorganization rules. That is true even if it were clear that reorganizations (standing alone) are wealth-creating transactions, since they would have taken place (and created the same wealth) anyway. This is a classic case of an ineffective subsidy. The only transactions the rules possibly promote are the inherently inefficient, purely tax-driven transactions. The large administrative, enforcement, and compliance costs are therefore a pure waste. The actual effect of the reorganization preferences is to provide a poorly designed, unfocused, and arbitrary subsidy to some participants in certain forms of M&A transactions. Who are these benefactors and what do they receive? This will be discussed in Part III.C, but first I discuss some additional possible efficiency aspects of reorganizations.

3. Do reorganizations correct a market failure?

Are there any other possible efficiency explanations for the reorganization provisions? One explanation could be that they

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116. This is well known. *See* Norris Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183 (1957). A recent study showed that the tax features of the acquiring corporation, rather than those of the target corporation, primarily affect the transaction's structure. Merle Erickson, *The Effect of Taxes on the Structure of Corporate Acquisitions*, 36 J. ACCT. RES. 279, 296 (1998).

117. Sometimes it will be deemed a reorganization in order not to attract shareholders' resistance. Obviously, they will be less likely to resist or further inquire into the transaction if it does not result in their current taxation.

118. *See* Wansley et. al., *supra* note 64, at 19.

119. Therefore, these transactions cannot justify the subsidy. *See* Schizer, *supra* note 23.

correct a market failure and optimize the amount and volume of such transactions. There is no clear answer as to whether the use of the market for corporate control is efficient, however. Nevertheless, some recent studies provide powerful evidence of the central role and comparative advantage of markets over management as efficient means of restructuring industries. Holmstrom and Kaplan, in particular, furthered the theory that capital markets are superior to the corporate governance structure (primarily management) in restructuring industries and allocating capital efficiently among industries required to restructure as a result of deregulation and technological changes (i.e., new information and communication technologies).[120] Managers not only have misaligned motivations, but also cannot respond as quickly, effectively, or appropriately to changes.[121] They conclude that a more market-oriented style of corporate governance is probably here to stay, with the focus on shareholder value, to which management has adapted and aligned its own interests (through the new executive pay schemes). Holmstrom and Kaplan's prediction is realistically reserved, since they acknowledge that the market for corporate control is constantly changing and that some of the effects may be temporary. Moreover, they emphasize that M&A transactions, and M&A waves in particular, are caused by a complex combination of factors.[122]

There is ample evidence on market failures that may fit a theoretical "corrective" efficiency explanation like the one mentioned above. The problem is that there is no correlation between such potential market failures and the operation of the reorganization provisions. The opposite is true—these provisions are more likely to facilitate market inefficiencies rather than mitigate them. Information gaps, which allow management to abuse all other

120. BENGT HOLMSTROM & STEVEN N. KAPLAN, CORPORATE GOVERNANCE AND MERGER ACTIVITY IN THE U.S.: MAKING SENSE OF THE 1980S AND 1990S, at 2, 23–24, 28–29 (Mass. Inst. Tech. Dep't of Econ., Working Paper No. 01-11, Feb. 2001), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID261112_code010221500.pdf?abstractid=261112.

121. It is interesting to compare this academic theory to the comment by John Vogelstein, *Comment*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 358 (John C. Coffee, Jr. et al. eds., 1988), who, as a practitioner, explained that the pace of takeovers was very fast and the rational analysis in most transactions was either limited or nonexistent. He believed that excesses in takeovers were brought about by "speculation, ego, and greed." *Id.* at 359.

122. HOLMSTROM & KAPLAN, *supra* note 120, at 14. This insight seems trivial, but it should always be kept in mind when one is to engineer policy relating to M&A transactions.

players in this market, represent probably the single most significant inefficiency potential. Selfish management maneuvers have proven to be a valid, though partial, explanation for M&A transactions. These maneuvers are also the only significant nonvalue-maximizing explanation.[123]

C. Motives for and Explanations of M&A Transactions

It should be clear at this point that the reorganization provisions cannot be justified on efficiency grounds, but only a deeper look into M&A transactions will expose the actual complication of the efficiency analysis of these transactions and the inadequacy of their tax treatment. In this subpart, I review the evidence from external literature about M&A transactions and their efficiency properties. I have two purposes for discussing the major findings of this literature with respect to the validity of the theory regarding motives and explanations in M&A transactions. My first purpose is to identify the benefactors from the reorganization provisions and determine whether the tax benefit they receive may be somehow justified. My second purpose is to explore evidence that may be helpful in the next subpart, where I test the correlation between the current reorganization provisions and the efficiency properties of M&A transactions.

1. The market for corporate control

The basic, naïve outlook on M&A transactions is that there is a market for corporate control that disciplines managers of corporations with the threat of a takeover and loss of status if they do not maximize their corporation's share value.[124] Managers,

123. This is probably the right place to clear two additional "noises" from the system. First, some may say this whole discussion is moot since reorganizations are utilized largely in a related-party, or even a single-entity, context, so one should perhaps bifurcate the market further to analyze each distinguishable context separately. This may be a good idea for further study, but I have decided to focus here on the "mainstream" reorganizations, in order to make this essay understandable to nontax-adept readers. This analysis would not look different even if I did include all the relevant situations. However, I do not even have to prove this, since there is further evidence that the general efficiency of M&A transactions in the long run is independent of whether the combined corporations are related or not. *See* Romano, *supra* note 91, at 127. Second, as discussed already, the external literature provides evidence that tax benefits in general do not drive M&A transactions; the benefits of the reorganization provisions could not *a fortiori* be considered a major factor in the initiation of such transactions. *See supra* notes 66–89 and accompanying text.

124. Manne, *supra* note 79, at 111–13.

therefore, have an incentive to be effective and maximize shareholder wealth rather than serve their own interests. Nevertheless, the managers-shareholders agency problem is not fully solved by the market for corporate control since takeovers (especially if opposed by managers) are costly.[125] Some studies even provide evidence that takeovers are, in fact, motivated by managers' utility maximization and therefore "are the paradigmatic agency problem, not its cure."[126] Tension exists between the market-efficiency and agency-problem explanations to the corporate phenomenon.

The standard view of M&A transactions has been challenged by extensive studies. Unfortunately, even today few conclusions have been drawn. Nevertheless, it is fair to say that the empirical evidence is consistent with the premise that M&A transactions generally promote efficiency as wealth-creating transactions.[127] These transactions generate abnormal gains for the target corporation's shareholders.[128] There is no decisive evidence showing consistent positive abnormal returns to the acquiring corporation's shareholders after such a transaction.[129] This result may seem strange, since the acquiring corporation is supposedly the *active* initiator of the transaction. One explanation for this is simply that management enters M&A transactions with the purpose of maximizing its own utility rather than its shareholders' wealth.[130] Another less skeptical explanation is that M&A transactions do have the purpose of shareholder wealth maximization, but for several reasons this purpose is not reflected in the share price right after the M&A announcement (in comparison with its pre-announcement price). Most of the economic and business literature that explores the consequences of M&A transactions consists of event studies of the immediate postmerger share price changes. An alternative line of

125. FOUNDATIONS OF CORPORATE LAW 230 (Roberta Romano ed., 1993) [hereinafter FOUNDATIONS].

126. *Id.* (referring to Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, *in* FOUNDATIONS, *supra* note 125, at 241).

127. This part heavily relies on the excellent review by Professor Roberta Romano, *supra* note 91, at 120.

128. This is more so the case in hostile takeovers. Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983); Jensen, *supra* note 78, at 314.

129. There is not even such evidence in the takeover context. Jensen, *supra* note 78, at 314.

130. Romano, *supra* note 91, at 123, 145–52.

studies explores the long-term effects. These studies have found that the average takeover destroys corporate value in the long run.[131] Newer studies provide evidence of long-term performance improvement after the merger,[132] consistent with the findings that M&A transactions are value creating and socially beneficial.[133] These mixed results do not affect my analysis, since even under the more optimistic results, it does not seem currently possible to extract situations where M&A transactions are clearly desirable and pinpoint the circumstances for the conclusion of such transactions. If there were means to do that in a reliable manner, it might have been possible to explore the weaknesses of the reorganization preferences and possibly fix the rules to make them desirable. My conclusion, however, is that the current data do not allow us any insights that may encourage such a belief.

2. Efficiency explanations for M&A transactions

One set of explanations for M&A transactions assumes a value-maximization motive behind the decision to enter into such transactions. Professor Romano, in an important work in this field, categorizes the various explanations of this kind into three types: efficiency, expropriation, and market inefficiency.[134] In this Article, I follow her classifications.

I begin with efficiency explanations for M&A transactions. The first, and most straightforward, efficiency explanation for M&A transactions is the hunt for synergy gains. Synergy gains are achieved if the value of the reorganized (combined) firm is greater than that of the reorganizing entities prior to the reorganization. One reason for this greater value may be in more efficient operations

131. Sherry L. Jarrell, The Postmerger Performance of Corporate Takeovers (July 2000) (unpublished manuscript, on file with author) (reviewing this literature, referring to Jensen & Ruback, *supra* note 128, and other studies from the 1980s).

132. Jarrell develops a methodology that compares the postmerger performance with the projected performance absent the merger. It finds that the long-term performance is significantly better than it would have been without the merger, justifying the perception of mergers as socially beneficial in general. Her results show impaired performance in the first one to two years postmerger, and a significant improvement in the next four to six years. Jarrell's study covered sample takeovers from the years 1973–1985. *Id.*

133. Romano, *supra* note 91, at 125 (referring to a former draft of Jarrell, *supra* note 131). It is interesting to see that these findings are independent of whether the transaction is between related or diverse firms. Jarrell, *supra* note 131, at 28. This finding challenges the validity of the tax distinction between these types of transactions. *See infra* Part IV.

134. Romano, *supra* note 91, at 123.

(operational synergy).[135] Recently, Maquieira and others[136] found significant net synergistic gains even in nonconglomerate forms of pure stock-for-stock mergers, reinforcing the reality that conglomerate mergers are not wealth-creating. This increases doubts about theories predicting that financial synergies motivate some (primarily conglomerate) mergers.[137] On the other hand, it strengthens the currently weak case for operating synergies in stock-for-stock transactions (usually predicted in a nonconglomerate form).[138] An interesting aspect of this study is that it analyzed the effect of M&A transactions on a variety of securities and stakeholders and concluded that the wealth created in nonconglomerate stock-for-stock mergers was shared by almost all classes of securities holders.[139] To the extent security holders can affect M&A activity,

135. This efficiency results from a better match of management to resources in the post-M&A firm. *See id.* at 126 n.20; *see also* Paolo Fulghieri & Laurie Simon Hodrick, Synergies and Internal Agency Conflicts: The Double-Edged Sword of Mergers (May 2001) (unpublished manuscript, draft on file with author) (developing this explanation in their study of the effect of asset specificity on M&A activity). Another example of operational synergy gains are simply economies of scale. Romano, *supra* note 91, at 126. The literature tracking the 1980s M&A transactions found larger returns in M&A transactions with firms in related businesses, and significant gains arose from the reallocation of assets of the acquired firms to related acquirers. *Id.* In addition, Wansley and others found abnormal returns in M&A transactions involving corporations with similar financial profiles. J. Wansley et al., *Abnormal Returns from Merger Profiles*, 18 J. FIN. & QUANTITATIVE ANALYSIS 149, 160–61 (1983).

136. Carlos P. Maquieira et al., *Wealth Creation Versus Wealth Redistribution in Pure Stock-for-Stock Mergers*, 48 J. FIN. ECON. 3 (1998). The sample used in this study consisted of all publicly traded corporations involved in pure stock-for-stock mergers between January 1963 and March 1996.

137. *Id.* at 6, 16–18, 29.

138. *Id.*

139. *Id.* Surprisingly, they found significant wealth increases to convertible bondholders in both forms and convertible preferred stockholders in nonconglomerate mergers. Even more surprising is that often the acquiring corporation's convertible bondholders benefit more than those of the target. Explanation of these findings awaits further study. A realistic observation may be that convertible bondholders of the bidding corporation enjoy favorable conversion terms, since they may include a large proportion of insiders and their "companions," which generally suggests wealth redistribution motivations. Another study using a sample from a similar period, though examining more than stock-for-stock transactions, similarly found overall positive net wealth creation effect of M&A transactions. KEWEI HOU ET AL., DOES TAKEOVER INCREASE STOCKHOLDER VALUE? (Eur. Fin. Ass'n, Working Paper No. 0488 2000), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID246151_code001101510.pdf?abstractid=246151. They used a 1963–1995 sample and, similarly to Maquieira and others, *supra* note 136, explored the overall effect on their sample as a "portfolio." Additionally, they tried to combine short-term and long-term wealth creation results of mergers. They found little difference between vertical and horizontal transactions. Further they found that cash offers dramatically outperform stock offers, supporting, like Hou and others, the management-disciplinary explanations of M&A transactions.

and with respect solely to nonconglomerate transactions, this study does not present results that discard the efficiency justification for the reorganization provisions.[140]

Another reason for the greater value found in the post-M&A firm may be financial synergy, which reduces the cost of capital to the firm. A reorganized firm should be able to more efficiently redeploy its cash internally across divisions.[141] As a by-product, the tax motivation to retain earnings, rather than distribute them, encourages the firm to use (the larger) retained earnings to internally finance projects. This is significant because returns on internally financed projects are lower than the marginal cost of capital were the projects to be financed externally.[142] Second, the reorganized corporation may be less exposed to bankruptcy, being potentially more diversified.[143] Finally, there may also be tax and accounting benefits resulting from diversification.[144]

A second efficiency explanation for M&A transactions is that they reduce agency costs. This is the traditional, naïve view—that a firm with inefficient management will be exposed to takeover by another firm, whose more efficient management will increase the value of the target unrealized by the failing management prior to the

140. I could not find support for another condition for this conclusion—that the tax (deferral) benefit plays any role in the decision-making process of security holders. I do not develop their role here, nor do I discuss the effects on shareholders who are also security holders.

141. Romano, *supra* note 91, at 128.

142. *Id.*

143. Diversification, nevertheless, is not necessarily a value-maximizing motive, nor has it proven to be, in general, a wealth-creating strategy. *Id.* at 128, 146–48. The basic idea is that, apart from the special case of bank mergers, investors do not need M&A to diversify. They can diversify themselves in a less costly manner. Diversification as a motive became most important with the rise of conglomerates as a business model in the third M&A wave of the 1960s, which has proven to be a failure. Nevertheless, in some deals, these diversifying transactions resulted in notable successes, such as the GE story. *See* GAUGHAN, *supra* note 68, at 123–33.

144. *See, e.g.*, GAUGHAN, *supra* note 68, at 154–58. The accounting benefits involved primarily the use of the pooling method of accounting, which has been limited over the years, cannot represent a real efficiency gain, and is similar to tax-motivated M&A transactions. *See* Romano, *supra* note 91, at 127. Studies showed, nevertheless, that the market could discern accounting gains from real economic gains, and, in reality, such accounting synergy gains do not motivate takeovers. *Id.* at 128 & n.28 (referring to Hai Hong et al., *Pooling v. Purchase: The Effects of Accounting for Mergers on Stock Prices*, 53 ACCT. REV. 31 (1978)). New accounting rules eliminated pooling transactions at the end of 2000, but the data proves that, in fact, pooling transactions did not generally result in higher accounting gains than purchase transactions. *See* Flom, *supra* note 82, at 769–70.

takeover.[145] This way, the market for corporate control keeps the capital market competitive.[146] Some studies support this outlook and even its application to nonhostile cases where efficiencies have been evidenced postmerger without indication of operation synergy gains, leading Romano to attribute them to better management.[147] In any event, this explanation does not apply to cases in which the incumbent management is retained by the acquirer.[148] Finally, management-supported buyouts may also be explained by the mere fact that after the transaction management becomes a larger shareholder.[149]

3. Expropriation explanations for M&A transactions

The expropriation explanations assume that M&A transactions do not create new wealth, but rather redistribute wealth from one sector of the economy to another. Most of the discussion has been over whether they transfer wealth from shareholders to bondholders (or stakeholders in general) or vice versa.[150] The most typical of these explanations concentrates on the potential tax benefits of takeovers,

145. Romano, *supra* note 91, at 129 (referring to the classical Manne, *supra* note 79).

146. Note that this rationale is not relevant to mergers, management-friendly acquisitions, or single-entity/single-group reorganizations.

147. Romano, *supra* note 91, at 130.

148. Jensen provided an agency cost reduction explanation to takeovers even in these circumstances in his "free cash flow" theory. Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986). Free cash flow is the excess of cash over the corporation's need for projects generating positive net present value returns. Shareholders would like it to be distributed, but management's interest is to retain it under their control. For various reasons, management wants to expand the firm beyond the size that maximizes shareholders' wealth and stay away from the supervision of the capital markets. Takeovers eliminate such free cash flow, but keep the power of this cash in the hands of management in the form of the acquired target. Managers will do that even if the expected returns are low or negative, since their alternative is to distribute the cash and completely lose control over it. This theory also explains the high returns to target shareholders versus low returns to the acquiring corporation's shareholders. Interestingly, if and when this theory applies, we expect cash to be the major, if not the sole, consideration. These transactions, therefore, should generally not benefit from tax advantages.

149. The buyout also has an obvious greater incentive to enhance productivity, blurring the agency problem by mixing in the interests of management as shareholders. *See* Romano, *supra* note 91, at 133. This explanation has limited application—it applies to management-supported buyouts only.

150. New research, nevertheless, widened the scope to include more specific groups, distinguishing between different stakeholders, to make the incentive picture even more convoluted. *See* Maquieira et al., *supra* note 136.

which I discuss separately below.[151] A nontax explanation of this type focuses on leveraged buyouts (LBOs), claiming that they are designed to expropriate wealth from the corporation's bondholders.[152] This explanation, however, is not supported by sufficient convincing evidence—bondholders' losses were too small compared to shareholders' gains in takeovers.[153] A more interesting expropriation explanation focusing on especially hostile takeovers has been that they are designed to expropriate wealth from employees. The argument is that a takeover is an attractive event for shareholders, since it allows them to behave opportunistically and earn abnormal returns knowing that the bidder will have less commitment to the corporation's employees.[154] This explanation is not currently believed to be powerful enough to motivate takeovers, *a fortiori* other M&A transactions. Finally, it has been argued that M&A transactions increase market power and allow the combined corporation to attain greater (monopolistic) income from rents, expropriating wealth from consumers. This explanation related mainly to the first M&A waves and diminished as antitrust law developed.[155] In many cases, M&A transactions involve unrelated businesses, where this explanation is even less relevant.[156] In

151. *See supra* Part III.B.2.

152. A more leveraged corporation is a riskier investment, but the bondholders are typically not compensated for this change in their risk position in advance. In effect, such transactions redistribute wealth from the bondholders to the shareholders, Romano, *supra* note 91, at 136–37, and, potentially, to management.

153. *Id.* at 137. Moreover, LBOs were used mainly in the fourth M&A wave, but have declined in importance since, and seem not to be of further concern at the present. No new study provides evidence that changes the conclusion that this explanation is not a significant motive to enter M&A transactions.

154. Shleifer and Summers, *supra* note 83, at 53, have developed this "breach of trust" explanation, arguing that there is an implicit contract between the employees and their management and shareholders. This contract, a long-term commitment to the employees, cannot be easily breached. A takeover is one event where it could, since the bidder has no part in this contract. In that event, therefore, shareholders can "walk away" with (at least a share of) the value that this contract represents—a value that would have belonged, otherwise, to the employees, without any further consequences. This explanation was criticized both for the use of the "implicit contract" terminology and for its validity. Romano, *supra* note 91, at 139. For my purposes it is enough to mention two arguments: first, in cases where an explicit contract could have been used, the employees chose not to use it, and therefore, had always had the conscientious risk of forfeiture; second, it is hard to find persuasive identification of specific value that could have been subject to such a contract. There is no empirical evidence significantly supporting it either. *Id.* at 140–42.

155. Romano, *supra* note 91, at 142.

156. Additionally, there is no convincing empirical evidence supporting this explanation. Jensen, *supra* note 78; *see also* Romano, *supra* note 91, at 142–43.

conclusion, expropriation explanations of M&A transactions are not convincingly supported by empirical study and are therefore generally irrelevant to my project.

4. Market inefficiencies as a driver of M&A transactions

Market inefficiency explanations assume unequal information in the market for corporate control, such as in situations where the buyer identifies an undervalued target (a corporation worth more than its aggregate stock value) and raids it by paying a premium to its shareholders. This premium has been proven to be lower than the real value of such stock. This straightforward, but unsupportable,[157] version explains target undervaluation as due to simple pricing errors. A more sophisticated explanation argues that investors overvalue short-term profits and undervalue long-term profits, and therefore firms that heavily invest in long-term planning and R&D are generally undervalued by the market and more exposed to takeovers.[158] Managers who identify this phenomenon will also tend to behave inefficiently and shift resources from long-term projects to short-term projects.[159] This myopic behavior is observed in the market, but not to the effect of initiating takeovers or other M&A transactions. Therefore these studies are also not relevant to my proposal.[160]

5. M&A transactions driven by management interests or incapabilities

There is an important group of explanations that do not assume value-maximizing motives behind these transactions, but rather management-interest maximization. Managers seek to increase their power and wealth, a phenomenon commonly called empire-

157. A worthy line of future study could be to reevaluate this conclusion in light of the high-tech frenzy of the late 1990s.

158. Romano, *supra* note 91, at 144.

159. Since this behavior was not found to be material in actually driving M&A transactions, and, even if it was found to be material, I believe that it would not be realistic to base legal rules on such abstract myopic behavior, especially when we do not sufficiently understand it and are not capable of measuring it. In a sense, this explanation is also an efficiency-enhancing explanation and an expropriation explanation in that it redistributes wealth (what is this unknown item that is redistributed?) from the future to the present. *Id.* at 144–45.

160. Even assuming that this phenomenon is real, we obviously do not want to support it with a tax subsidy.

building.[161] This explanation is supported by several empirical studies,[162] and is at least a partial factor behind M&A transactions.[163] A similar explanation focuses on the risk, rather than the upside, to management. M&A transactions provide management with an opportunity to diversify their business; diversification may reduce the risk of bankruptcy, increase debt capacity, and reduce operational risks.[164] Except for special cases,[165] this is not very helpful or attractive to investors, who can diversify their holdings more cheaply at the portfolio level.[166] Managers, whose eggs are in one basket (of the specific firm), may very well benefit from diversification at the corporation level, even at the expense of their shareholders.[167] Diversification, in general, found little support as an important explanation for M&A transactions in the literature.[168]

Richard Roll argued that although managers do try to make value-maximizing acquisitions, they fail to correctly value their targets.[169] Therefore, they generally pay too much and refuse to admit their mistake even after the bid has commenced and share prices have fallen. Thus, takeovers result in wealth transfers from the acquiring corporation's shareholders to the target's shareholders. This hubris theory is only partially supported by empirical evidence and, at any rate, cannot completely explain the M&A phenomenon, since the evidence shows that takeovers result in efficiency gains, not only in wealth transfers.[170] Moreover, bidders should have learned from this experience, or at least should have been advised on it, and therefore this explanation may only have validity, if at all, in minor cases or with respect to first-time, ill-advised bidders. In contrast,

161. Romano, *supra* note 91, at 148.

162. *Id.* at 148–49.

163. A variant of this explanation uses Jensen's "free cash" theory, *supra* note 148, which is partially supported by some studies. Romano, *supra* note 91, at 149–50.

164. Romano, *supra* note 91, at 146.

165. Bank mergers are one example. *See id.*

166. This is the case, as already demonstrated, from the shareholder's point of view. *Id.*

167. *Id.* at 147–48. Romano adds a value-maximizing variant to this explanation, stating that possibly the managers' ability to diversify allows the shareholders to reduce their compensation, so both sides are better off. This efficiency "spin," nevertheless, is not supported empirically.

168. *Id.*

169. Managers may also fail to correctly evaluate their own ability to turn the failing acquisition around. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

170. *See* Romano, *supra* note 91, at 151–52; Wansley et al., *supra* note 97, at 412.

Shleifer and Vishny argue that management acts rationally, expecting, identifying, and reacting to stock market inefficiencies that result in incorrect valuation of the stock involved in the transaction.[171]

In a recent study, Rau and Vermaelen introduced an angle that further complicates the picture.[172] They discovered differences between "glamour firms" (corporations with low book-to-market ratios—a positive measurement for management performance) and other firms. In support of the hypothesis that markets over-extrapolate the past performance of the bidder when assessing the value of acquisitions, the researchers found that glamour firms' managers overestimate their abilities to manage a target corporation. They attribute this phenomenon to management hubris.[173] On the other hand, the managers at "value firms" (those with bad past performance) are much more restricted by internal disciplinary means. The restrictions better assure that M&A transactions are motivated by shareholder value creation and not by management hubris. The conclusion is that the market fails to understand that past managerial performance is not a good indicator of future performance, at least in the case of acquisitions.[174] This failure does explain why we identify short-term positive returns upon M&A transactions, followed by long-term underperformance. Nevertheless, not all of the glamour managers are interested in short-term gains, so the original puzzle is not solved.[175] The distinction between glamour

171. ANDREI SHLEIFER & ROBERT W. VISHNY, STOCK MARKET DRIVEN ACQUISITIONS (Nat'l Bureau of Econ. Research, Working Paper No. 8439, 2001), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID278563_code011004600.pdf?abstractid=278563.

172. P. Raghavendra Rau & Theo Vermaelen, *Glamour, Value and the Post-Acquisition Performance of Acquiring Firms*, 49 J. FIN. ECON. 223 (1998).

173. *Id.* at 225, 251. For Roll's management hubris explanation, see *supra* note 169.

174. Rau & Vermaelen, *supra* note 172, at 251.

175. Another interesting distinction Rau and Vermaelen make is between mergers and tender offers, which are used interchangeably in some of the literature I survey here. They found significantly lower returns in mergers compared to tender offers, both in "glamour" and "value" firms. *Id.* at 227. For similar results, see T. Loughran & A. Vijh, *Do Long-Term Shareholders Benefit From Corporate Acquisitions?*, 52 J. FIN. 1765, 1789 (1997). This finding is not new and can be easily associated with the other literature on the different returns of different means of payments, documenting consistently higher returns in cash payments than in stock transactions, which are more typical in mergers. The authors also add that many of their results are also consistent with the means of payment hypothesis just described. *Id.*; *see also* Wansley et al., *supra* note 97 (supporting the payment method signaling hypothesis). It is possible to argue that glamour firms time their (stock) payments with overvaluation of their

and value firms, and the different processes they experience in M&A transactions, is also ignored by tax law, which is generally not sensitive to inefficient and socially undesirable "managerialism."

Management-related explanations are not convincingly supported by empirical studies. Nonetheless, transactions actually driven by such motivations are likely to be inefficient, since maximizing shareholders' wealth is not in the interest of managers. For the same reason, these transactions are also most likely to be manipulated to maximize their tax benefits and are more likely to be stock rather than cash transactions.

6. *The importance of deregulation*

Andrade, Mitchell, and Stafford provide another perspective on M&A transactions, emphasizing the important role of industry shocks on the volume of M&A activity in the specific industry.[176] The identification of industry shocks as a factor in the evolution of merger waves has been recognized for some thirty years, but only recently have studies provided evidence successfully tying mergers to specific industry shocks.[177] It is well known that mergers cluster not only in waves but also by industries. It is also apparent now that the various motives that have been proven relevant to M&A transactions are not always relevant. In particular, Andrade and others provide evidence of one significant industry shock that has affected several industries—deregulation, which, they conclude, accounts for nearly half of M&A activity since the late 1980s (the fifth merger wave).[178]

firm's stock. Rau & Vermaelen, *supra* note 172, at 251; *see also* Loughran & Vijh, *supra*. An earlier study by Henri Servaes found evidence showing that more value can be created from taking over poorly performing companies, consistent with the simple story of the market for corporate control. Henri Servaes, *Tobin's Q and the Gains from Takeovers*, 46 J. FIN. 409 (1991). This is somewhat in contrast to Rau and Vermaelen, but the evidence relates to an earlier sample. Moreover, the validity of its methodology is questionable as well.

176. GREGOR ANDRADE ET AL., NEW EVIDENCE AND PERSPECTIVES ON MERGERS (Harv. Bus. Sch., Working Paper No. 01-070, 2001), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID269313_code010523500.pdf?abstractid=269313.

177. *See id.* at 6 n.7.

178. In their words: "[W]e can say without exaggeration or hyperbole that in explaining the causes of mergers and acquisitions, the 1990s were the 'decade of deregulation.'" *Id.* at 3. I note that they used a 1973–1998 sample. One other current important article in the field of M&A transactions also emphasizes the role of deregulation in the merger wave of the 1990s, together with new information and communication technologies. *See* HOLMSTROM & KAPLAN, *supra* note 120, at 2. Their empirical evidence corresponds to that of ANDRADE ET AL., *supra* note 176.

Interestingly, the abnormal returns to target shareholders are consistent throughout the years in spite of the differences between the waves and industries involved.

It is also clear that the shareholders of the acquiring corporarion do not similarly benefit from participation in M&A transactions. It cannot be conclusively determined that they lose wealth in these transactions, but even if they benefit from them, the benefit is relatively small. Interestingly, Andrade and others conclude that it is important to separate stock-financed M&A transactions from other transactions in order to accurately evaluate their effect, since these transactions inherently embed an equity issue that normally bids down the stock price.[179] After this separation, they conclude that, in line with other studies that I have elaborated on, stock-financed mergers do ***not*** increase overall shareholder value in the short term. The long-term analysis, imprecise as it is,[180] makes it even worse for stock-financed transactions, which suffer negative abnormal returns relative to cash-financed mergers.[181] This study seriously challenges the efficiency of the tax subsidy that we grant to such stock transactions. An interesting question is whether we can apply the tax subsidy exclusively to restructuring industries where efficiency benefits and nontax motivations are more likely to drive M&A activity. Of course, even if we could, this would probably be an ineffective and still-inefficient subsidy since it is reasonable to argue that these transactions will most likely take place anyway.

7. *The effect of asset specificity on M&A activity*

Another important factor in the initiation of M&A transactions, which has been explored in a recent study, is the degree of asset specificity in the involved firms or industries, i.e., the excess value of an asset in the relevant firm in comparison with its value in an alternative use.[182] Fulghieri and Hodrick found that the performance of diversifying mergers improves as their degree of asset specificity

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179. ANDRADE ET AL., *supra* note 176, at 10.

180. *Id.* at 12–13.

181. This is an interesting result; nevertheless, the methodological soundness and its importance are still in doubt. Andrade and others, *supra* note 176, reasonably chose to mention it without allowing it to affect their conclusions.

182. Fulghieri & Hodrick, *supra* note 135.

increases.[183] The intuition they prove is that in merging firms with a high degree of asset specificity there is a smaller chance that internal battles will change operational assignments for the worse, generating negative internal agency effects that are more likely to occur in M&A transactions between firms with a low degree of asset specificity. Their findings prove that the positive synergy effects of mergers outweigh these potential negative internal agency effects if they are particularly large, or, when they are only moderate, in firms with high degrees of asset specificity. These results can be generalized and help explain the concentration of M&A activity by industries.[184]

8. *Conclusion: the material motivations and explanations of M&A transactions*

The classic external literature[185] supports mainly the synergy gains and the agency cost-reduction explanations of M&A transactions, complemented by some management-driven explanations.[186] No single explanation has sufficiently powerful empirical support or has been proven to apply equally to all transactions.[187] Recent literature reinforces these results and adds insight on the importance of additional factors. The more important additional factors include industry shocks, in general, and deregulation in certain industries, in particular. Asset specificity is also helpful in explaining the concentration of M&A transactions by industries. This complexity and multiplicity of relevant factors exposes further the inadequacy of the stable, but crude and unsophisticated, tax rules that apply to these transactions.

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183. *Id.* (comparing the consistency of their results with an earlier study, Randall Morck & Bernard Yeung, *Why Firms Diversify: Internalization vs. Agency Behavior*, *in* INTANGIBLE ASSETS: VALUES, MEASURES, AND RISKS 269 (John Hand & Baruch Lev eds., 2003), *available at* http://pages.stern.nyu.edu/~byeung/firms.pdf.

184. Fulghieri and Hodrick also predict that in mergers of corporations with high degrees of asset specificity, equity financing is more likely than debt financing since debt is an established mechanism to control internal agency costs (restriction and control over management) and is less necessary in such cases where it is controlled by the asset composition of the merging firms. This prediction has, nevertheless, yet to be substantiated. *See* Fulghieri & Hodrick, *supra* note 135.

185. See Romano, *supra* note 91, at 123–24, for additional theories that I chose to preclude from this review.

186. *Id.* at 152–53.

187. *Id.*

I now take the next step and review the lack of correlation between the major components of the current tax regime and the efficiency-enhancing features of M&A transactions.

D. No Correlation Between the Tax Laws and the Efficiency Features of M&A Transactions

A primary feature of the reorganization provisions is their application solely to stock compensation. My analysis up to this point has demonstrated that the available economic and finance studies could not support an assertion that the transactions qualifying as reorganizations, standing alone, are wealth-creating overall. From an efficiency perspective, the pro-stock bias of these rules is, at best, questionable. In fact, tax distortions themselves contribute to the relative inefficiency of such transactions, especially when compared to all M&A transactions. Another interesting result of the above review is that the big winners in M&A transactions in general are the target shareholders, and, potentially, the managers involved in the transaction. The main effect of the reorganization preferences is to subsidize exactly the same population—target shareholders—since they are the only ones that may defer current taxation. The necessity of this subsidy to target shareholders is questionable in this light, but beyond my scope here.[188]

A second major feature of the reorganization preferences is the requirement of business continuity. This requirement is satisfied by the continuity of either the historical business *or* its assets.[189] From a business perspective, these two alternative requirements are significantly different. The first may mean that intra-industry transactions may qualify as reorganizations, but it also means that vertical and conglomerate transactions are acceptable as long as the original business is maintained. From an efficiency standpoint, therefore, this requirement is not very useful. It may even be harmful, since it also supports the currently undesirable conglomerate transactions and may discourage more efficient reallocations of business assets across industries. The other prong of this requirement mandates that the bulk of the historical business assets are transferred *together*, i.e., not necessarily each asset

188. The subsidy raises fairness questions in addition to efficiency issues relating to managerialism and the wasteful costs-of-agency problems supposedly encouraged by these provisions.

189. Treas. Reg. § 1.368-1(d) (as amended in 2001).

separately to its value-maximizing target. A relevant aspect explored in the literature is the importance of asset specificity as an indicator for potentially desirable M&A transactions.[190] This finding relaxes the above-mentioned effect of the second requirement, since in transactions involving firms with high levels of asset specificity this happens naturally. It is hard to weigh these conflicting potential effects without further study, but in general the business-continuity alternative requirements do not seem to make sense from an efficiency standpoint. The business-continuity requirement is written in a way that ignores much of the available business knowledge about the transactions to which it applies. For example, it ignores the distinctions found between different industry types and their importance in determining some of the economic consequences of these transactions.

The third and historically most important reorganization requirement is that of target shareholder continuity, basically mandating that a substantial portion of the target shareholders is subjected to the risk of owning the acquiring corporation's stock immediately after the transaction. This requirement only applies to the result immediately after the transaction; target shareholders can dispose of such stock shortly after the transaction.[191] However, they are subject to the price fluctuations of the acquiring corporation's stock in the immediate short term. The effects of this requirement are interesting: it subjects the target shareholders, the clear winners in M&A transactions, to either negative or only slightly positive returns for at least a short period of time. Their enrichment is therefore mitigated and potentially replaced by tax deferral advantages. There is no requirement that target shareholders have any influence, much less control, in the surviving entity. A reorganization therefore has the potential to enhance, rather than reduce, the costs of agency problems within the participating firms in M&A transactions.[192] Otherwise, this central requirement has no efficiency-enhancing effects.

The business purpose requirement does not necessarily target specific purposes. Rather, it requires "a" business purpose. From an

190. Fulghieri & Hodrick, *supra* note 135.

191. For the minimum holding period requirement, see BITTKER & EUSTICE, *supra* note 8, ¶ 12.21[5].

192. This enhancement of problems occurs because reorganizations necessarily dilute ownership.

efficiency perspective, motives are not important. They are, nevertheless, indirectly relevant, since management entrenchment and self-promotion likely result in inefficient consequences. This requirement is interesting since it at least has the potential to be utilized to promote certain transactions that we can identify as not inefficient and therefore mitigate some negative consequences of reorganizations.[193]

We see therefore that there is no correlation between any of the major components of the reorganization rules and the efficiency properties of M&A transactions.

IV. CONCLUSION—FULL TAXATION OF REORGANIZATIONS

My analysis shows that neither of the possible justifications I extracted from the legislative history and policy debate could sufficiently and sensibly support the preferential reorganization tax regime. First, the reorganization regime, as an exception to the realization requirement, cannot be justified by the standard rationale for the prevalence of this requirement in the income tax system—valuation and liquidity concerns. Neither can it be supported on efficiency grounds, as I demonstrated in Part III, which is the primary contribution of this Article. Second, the reorganization regime cannot be justified on the grounds that it is a desirable subsidy, or even a subsidy with some desirable properties, such as credibility.[194] It is ineffective and counterproductive as a subsidy to transactions that would have taken place regardless of the subsidy. Moreover, it is a poorly directed subsidy. Third, although not directly discussed at length in this Article, this regime likely has undesirable fairness consequences that benefit the upper class.[195] The conclusion is that the reorganization preferences are a costly and wasteful piece of legislation. The complexity of the rules and the constantly changing variety of M&A transactions (and explanations

193. I would reject this possibility since it also has the potential to be politically abused to promote only inefficient transactions. Our politicians' track record in adjusting the tax law to accommodate available economic evidence is poor, which is apparent from my discussion in this section and the multiplicity of the notorious "loopholes" in the tax system.

194. Schizer, *supra* note 23.

195. *See, e.g.*, Ip, *supra* note 24, at D2. The fairness angle is also much wider and applies to incentives to capital income earners (mainly the rich) in general. *See, e.g.*, Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 386, 388 (2002); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215 (2002).

for them) illuminate how crude and untargeted these provisions are, even though they have remained intact for eighty years, completely detached from the market reality.

In light of the lack of any substantively sensible reason to support the current reorganization regime, I am compelled to propose to completely eliminate it and tax all M&A transactions as they occur.[196] I understand that this is a difficult proposition to most experienced tax professionals, who generally prefer a familiar villain over an unknown one. I understand this approach and can partially attribute to it the impressive stability of these rules in the system.[197] However, I must reject it in this case, since taxing reorganizations is not a replacement, new, or unknown regime and since there is simply no clearly desirable feature in the current regime. The question is not of balance, since there is ***no*** material benefit in keeping the current regime rather than repealing it.

Professor Shakow proposed to do away with this preferential scheme in 1990 with respect to all corporate acquisitions (not only reorganizations)[198] following an ALI proposal to make the reorganizations subsidy elective,[199] adding that such action will require major changes in the tax law.[200] The primary reason for his (and the ALI's) proposal was simplicity. Shakow was concerned, for example, with the fact that even in a taxable merger only the shareholders of the disappearing entity may be taxed. The surviving entity's shareholders are never taxed in a realization-based system.

196. I do not attempt here to make a normative statement on other transactions, such as "internal reorganizations," although I have included some data on such transactions, which does not always expose significant differences between those transactions and the acquisitive reorganizations dealt with in this Article. Interestingly, the Code deals with these transactions sporadically, through § 368, as well as the consolidated returns rules. It is possible that the original purpose of reorganizations was to accommodate exactly these transactions, but they clearly did not evolve that way.

197. The other reason is political, namely, self-interest of all the decision makers.

198. David J. Shakow, *Wither, "C"!*, 45 TAX L. REV. 177 (1990). Another proposal, raised by Professor Coven, was to make all corporate acquisitions tax-free. Coven, *supra* note 10. Coven's proposal aims at other distortions of the income tax system, like the realization requirement and corporate tax. I assume these two are unlikely to change. So long as these do not change, Coven's proposal would result in a more distortive acquisition-driven economy. See also Shakow's more specific criticism, *supra*, at 208–12.

199. AM. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 22–312 (1982); *see also* Shakow, *supra* note 198, at 178. Shakow rightfully criticized the "fatalistic" approach of the ALI, but acknowledged that not allowing the election must result in the major changes he proposes to the tax law. *Id.* at 179.

200. Shakow, *supra* note 198, at 179, 193.

This may not be a serious path of tax avoidance in reality, but we do have fairly effective tools in the code to restrain it, such as those presented by Shakow himself. One such tool may be to always treat the larger entity as the surviving entity. This rule may be extended to reorganizations without significant costs.

I agree with Shakow's general approach, but in this Article I propose a more modest, limited, and less complicated proposal that does not require significant changes in the tax law. Reforming the taxation of all M&A transactions is complicated and, even under Shakow's sensible proposal, involves certain material policy uncertainties and risks. The repeal of the reorganization provisions alone may not be a complete reform—it is just a first step—but it is an inherently risk-free, efficient simplification step with no potentially undesirable effects.[201]

201. Shakow's other major concern was the equalization of treatment of transactions involving partnerships. In this regard, I think that it is not necessary to equalize their treatment to that of corporations. Two corporations could, indeed, form a partnership, rather than a corporation, tax free. They will not, nevertheless, avoid at least one level of corporate tax. They may avoid a second level of corporate tax, but that is not very disturbing since they could do that anyway under the current regime using an LLC, a "checked–the-box" entity, etc., or just by utilizing a dividend-received deduction. *Id.* at 205–06.

Appendix: History and Evolution[202]

I. LEGISLATIVE AND JUDICIAL BACKGROUND[203]

The corporate income tax was the first enacted income tax in America.[204] The Income Tax Act of 1894 attempted to tax corporate income, but was invalidated by the Supreme Court's decision in *Pollock v. Farmer's Loan & Trust Co.*[205] on the ground that such tax was a direct tax on income from real estate and personal property, not apportioned among the states in proportion to population as required by Article I, Section 9, Clause 4 of the Constitution.[206] Congress learned its lesson, and in 1909[207] it successfully enacted a corporate income tax based on the business activity of corporations rather than on their property.[208] This tax was validated just two years later by the Supreme Court's decision in *Flint v. Stone Trace Co.*[209] The ratification of the Sixteenth Amendment and the individual income tax followed in 1913.

The basic foundations of the income tax treatment of corporate structural changes were established in the Revenue Act of 1918,[210] following earlier Treasury rulings that no taxable income resulted from the exchange of property or stock for stock.[211] In addition to these rulings, the Act was instituted to settle the confusion created by several seminal cases on point, which took place prior to the 1918 Act. In *Unites States v. Phellis*,[212] the Supreme Court denied nonrecognition to a transfer of assets from a New Jersey corporation to a Delaware corporation, based on the theory of "separation"—a

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202. This section includes a historical review. It is intended to provide background of the tax code for the reader.

203. For a more comprehensive historical review, see Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. PA. L. REV. 1335 (1985).

204. This statement disregards the ancillary income tax that was enacted to fund the Civil War and was repealed in 1872. *See* http://www.irs.gov/irs/article/0,,id=98142,00.html.

205. 158 U.S. 601, *vacating* 157 U.S. 429 (1895).

206. *See* BITTKER & EUSTICE, *supra* note 8, ¶ 1.01.

207. The Payne-Aldrich Tariff Act of 1909, ch. 6, § 28, 36 Stat. 92 (repealed 1913).

208. *See* BITTKER & EUSTICE, *supra* note 8, ¶ 1.01.

209. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

210. The Acts of 1913, 1916, and 1917 contained no such provisions.

211. RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION 8 (3d ser. 1940).

212. 257 U.S. 156 (1921).

severance of value from the original equity investment of something of value "for [the] separate use, benefit and disposal" of the taxpayer[213]—distinguishing it from *Eisner v. Macomber*.[214] The Court mentioned the fact that the new corporation had been organized in a different state, but in another decision it ignored this argument.[215] A few years later it affirmed the rule,[216] which has been settled ever since, that this fact is meaningless.[217] Finally, in *Weiss v. Stearn*, the taxpayer won, and the Supreme Court applied its intuition that imposition of tax requires *something more* than a mere change in technical ownership, allowing even some cashing out as long as that did not affect the nature of the unsold portion.[218] As asserted by Professor Paul, "It would be a masterpiece of understatement to call the net result of the[se] cases . . . far from satisfactory. . . . Logic was having a fling at the expense of practical values in a world of metaphysics. . . . The result was complete confusion."[219] Apparently, the courts failed to make coherent law in this case, and the legislature had to step in. It is doubtful, however, if that has changed things for the better.[220]

This unclear legal background leading to the 1918 legislation was amplified by the high tax rates of that period, which created increased pressure by industry on the government to provide adequate guidance on the subject.[221] The result was the enactment of Section 202(b), providing nonrecognition treatment for exchanges

213. PAUL, *supra* note 211, at 11 (emphasis omitted).

214. 252 U.S. 189 (1920). *Eisner v. Macomber* is the leading case for nonrecognition treatment. The Supreme Court denied taxation upon the distribution of a stock dividend, which was held to be a mere capitalization of the profits of the distributing corporation, and not something that the shareholder had received out of the corporation's assets for his separate use and benefit.

215. *Rockefeller v. United States*, 257 U.S. 176 (1921), was decided similarly and on the same date as *Phellis*, but the sole difference in circumstances was that the new corporation had been organized in the same state. *See* PAUL, *supra* note 211, at 13.

216. The reasoning first appeared in a separate opinion in *Marr v. U.S.*, 268 U.S. 536, 542 (1925); *see also* PAUL, *supra* note 211, at 13.

217. The insignificant nature of the state of organization was later codified into the type "F" reorganization.

218. 265 U.S. 242 (1924); *see* PAUL, *supra* note 211, at 15–16.

219. PAUL, *supra* note 211, at 18.

220. As asserted by Posin, *supra* note 203, at 1347, "Since the Court had apparently dropped the ball, it seemed appropriate for Congress to step in and pick it up. Congress did so, but then proceeded to fumble it. In retrospect it might have been better to let the Court continue to grapple with the problem."

221. PAUL, *supra* note 211, at 9.

of property "in connection with the reorganization, merger, or consolidation of a corporation."[222] The rule adopted was that if, in connection with the reorganization, merger, or consolidation of a corporation, a shareholder exchanges her stock or securities for other stock or securities "of no greater aggregate par or face value,"[223] such shareholder will have recognized no gain or loss on the exchange. The stock or securities she receives will be treated as taking the place of those exchanged. A property owner exchanging such property with stock or securities in a corporation to which she has transferred her property was also granted the same treatment. Any par or face value (not fair market value) received in excess of the stock, securities, or property exchanged was treated as gain. These situations are, basically, the "stock-for-stock" and "stock-for-property" reorganizations as we know them today. Merger and consolidation transactions were also covered in the "stock-for-property" rule.[224] The legislative history indicates that such transactions were viewed at the time by the legislators as "purely paper transactions."[225] The Senate attempted to pass an even wider version of the nonrecognition treatment, but was stopped by the House.[226]

The 1921 Act, enacted in a more accommodating political and economic environment, attempted to provide better and more elaborate guidance on the basic rules for determining gains and losses on corporate transactions. The relevant code section remained Section 202, though now Subsection 202(c) treated exchanges of properties. The new general gain-recognition rule also created a new term—"readily realizable market value."[227] Subsection 202(c)(2) was

222. I.R.C. § 202(b) (1918), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938–1861, at 898 (1938).

223. *Id.*

224. No definition of a reorganization was legislated, and the legislation did not cover all of the situations raised in prior case law. A definition did appear later, in Treas. Reg., 45 art. 1567 (as amended in 1921). Interestingly, in *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481 (1937), the Commissioner argued that the 1918 Act had not exempted property-for-stock transactions (only stock-for-stock), in contrast to the regulation. The substantive argument was that merely formal changes are covered by the nonrecognition provision. The Supreme Court refused to look into the substance of this argument and accepted the Treasury Regulation as a correct interpretation of the statute. PAUL, *supra* note 211, at 19–21.

225. S. REP. NO. 65-617, at 5–6 (1918), *reprinted in* SEIDMAN, *supra* note 222, at 899.

226. H.R. REP. NO. 65-1037, at 44–45 (1918), *reprinted in* SEIDMAN, *supra* note 222, at 899.

227. I.R.C. §202(c) (1921), *reprinted in* SEIDMAN, *supra* note 222, at 789–90.

positioned as an exception to the rule's general requirement that there be recognition of the gain or loss realized in a transaction[228] if property received by a taxpayer in an exchange had such value. The exception applied if the exchange of property was part of a "reorganization." A "reorganization," therefore, was statutorily defined for the first time to include a merger, a consolidation, a stock-for-stock acquisition, a stock-for-assets acquisition,[229] a recapitalization, and a mere change in a corporation's identity, form, or place of organization.[230] Here we can see the establishment of the reorganization concept in a readily recognizable structure similar to Section 368 patterns.[231]

Moreover, Subsection 202(c)(2) also added another basic pillar in the reorganizations tax law. The "substantially all" concept[232] requires only a majority of both vote and value in the target corporation for the reorganization exception to apply. Prior to this law, supposedly, there was no leeway, and a transfer of all the stock of the target corporation was strictly required in order for taxpayers to realize the benefits of corporate nonrecognition.[233] The purpose of the new rule was to clarify the treatment of corporate structural

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228. Practically, the wording of this rule reversed the presumption under prior law that every exchange of properties is taxed unless it falls in the exception. As a result, the presumption became no taxation unless there is a readily realizable market value to the property exchanged. The reversal of this presumption was a result of excessive uncertainty and litigation under prior law. *See* H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 790.

229. The Senate Finance Committee Report adds, in this respect, that reorganization was meant to cover transfers of productive assets used in a trade or business for like-kind property. Similar lines of thought may influence the current continuity of the business enterprise requirement. *See* S. REP. NO. 67-275, at 12 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 791. Additionally, see the discussion in the Senate. 61 CONG. REC. 6,561–66 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 792–96. The discussion in the Senate added another conceptual requirement not yet formalized but familiar to us today—the business purpose requirement. *Id.*

230. The last two, which we recognize today as type "E" and "F" reorganizations, were introduced in the 1921 Act for the first time. There were also some additional suggestions for transactions that should be added to the list comprising this exception, but they were not included in the final act. *Id.* at 790–91.

231. These are basically today's "A," "B," "C," "E," and "F" reorganizations. I.R.C. §§ 368(a)(1)(A), (B), (C), (E), (F) (2000).

232. *Id.* § 368(a)(1)(C) (referring to properties transacted in the reorganization).

233. See also the discussion in the Senate. 61 CONG. REC. 6,561–66, 6,568 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 792–97. Interestingly, the same Act added Subsection 202(c)(3), the predecessor of § 351, using the word "control" and mandating an 80% requirement rather than the more than 50% requirement. I.R.C. § 202(c)(3) (1921), *reprinted in* SEIDMAN, *supra* note 222, at 790.

changes and reduce litigation. These corporate changes were described as required business "readjustments"[234]—events that were, but should not be, considered realization events. The legislative history further refers to the gains realized in such events as technical gains,[235] without actual cash profit,[236] and repeated the language referring to these transactions as paper transactions.[237] Cashing out from an investment became, therefore, one of the tests for a real (in contrast to a technical) realization event. The discussion in the Senate additionally provided the first seeds of doubt in this context. The criticism of both the overbroad scope of the reorganization provisions,[238] and of transactions that consist of shifts of risks,[239] demonstrate that the intention was to exempt from tax not only technical transactions involving no actual changes in the structure of the relevant corporate body, but also transactions that were considered by the critics to be "more of a sale than an exchange."[240] Indeed, this leeway and the attendant fair-market-value basis[241] in such like-kind exchanges opened the door to an extensive tax industry exploiting these provisions.[242] This situation led to the Act of March 4, 1923, which amended Subsection 202(c) to limit the reach of nonrecognition to exchanges of stock and securities, but

234. *See* H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 790. Interestingly, the committee also assumed that the new rule would increase revenue since it disallowed fictitious losses to taxpayers taking undesirable advantage of the nonrecognition treatment of Section 202. *Id.*; *see also* S. REP. NO. 67-275, at 11–12 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 791.

235. S. REP. NO. 67-275, at 11–12 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 791.

236. *Id.*

237. See the discussion in the Senate. 61 CONG. REC. 6,561–66 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 792–96.

238. The reorganization provisions also included transactions where only a mere 50% or more of control is retained in the "reorganized" corporation. I.R.C. § 202(c) (1921), *reprinted in* SEIDMAN, *supra* note 222, at 789.

239. When one corporation owns property X and it is reorganized into another corporation owning property Y, the remaining shareholders of both corporations now share the risks in each of the two properties.

240. See the discussion in the Senate. 61 CONG. REC. 6,568 (1921), *reprinted in* SEIDMAN, *supra* note 222, at 796–97.

241. Since no exception to the basic cost-basis rule was enacted with respect to reorganizations in 1921, *see* PAUL, *supra* note 211, at 23–24, the oversight allowed a free step-up in basis and easy tax avoidance, thereby frustrating the basic tax-deferral policy goal of these provisions.

242. H.R. REP. NO. 73, at 37–42 (Dec. 4, 1933), *reprinted in* SEIDMAN, *supra* note 222, at 332–38.

which, as a result, retained such treatment for mergers, consolidations, and reorganizations.[243]

The 1924 Act was the next act addressing material changes in the reorganization rules. It corrected the primary mistake of prior law by providing for exchange-basis treatment of property exchanged in a reorganization, rather than a fair-market-value basis,[244] thus substantiating the tax deferral, rather than concession, theory behind such transactions. The act attempted to comprehensively rearrange and clarify the corporate reorganization tax regime, serving as "the nucleus of all later acts."[245] In doing so, it developed the reorganization provisions and brought us even closer to current law by: (1) replacing the "readily realizable market value" equation with the known "amount realized" concept;[246] (2) providing, in Subsection 203(a), that, subject to the exceptions, the entire amount realized be recognized;[247] (3) retaining the exception for reorganizations, but adding requirements that the relevant taxpayers must be "part[ies] to [the] reorganization" and that the transaction must be "in pursuance of the plan of reorganization";[248] and (4) clarifying that nonrecognition also applies to corporations exchanging property for stock or securities in another corporation where both are parties to the reorganization of one.[249] The "reorganization" definition moved to Subsection 203(h) and added the type "D" reorganization, involving one corporation's transfer of assets to another corporation where such transferee corporation is controlled by the transferor or its shareholders immediately after the transaction.[250]

243. H.R. Res. 13774, 67th Cong. § 1 (1923), *reprinted in* SEIDMAN, *supra* note 222, at 797.

244. I.R.C. § 204(a) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 698.

245. PAUL, *supra* note 211, at 24.

246. I.R.C. § 202(c) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 686–87.

247. *Id.* § 203(a) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 687.

248. *Id.* § 203(b)(2)–(3), (c)–(h) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 689–97. Interestingly, not until 1937 did the Supreme Court provide some guidance about what a "party to the reorganization" means. The Court interpreted this requirement narrowly and eliminated some "natural" reorganization candidates in the famous leading cases of *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938). The *Groman-Bashford* doctrine was partially repealed by the 1954 Code, which provided guidance based on a more liberal interpretation. Later amendments expanded this repeal: in the 1964 Act, to type "B" reorganizations; in the 1968 and 1970 Acts, to forward and reverse triangular mergers, respectively; and, in the 1980 Act, to bankruptcy reorganizations.

249. I.R.C. § 203(b)(3) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 690.

250. *Id.* § 203(h)(1)(B) (1924), *reprinted in* SEIDMAN, *supra* note 222, at 697.

The congressional discussion evidenced very interesting and harsh criticism of the rules corrected in 1924:

> There is no more frequent or common course of evasion at the present time than the provisions of the present law with reference to reorganization of corporations. They are so extremely broad and so loose that you could drive a four-horse team through them, and any good corporation lawyer can provide a method of reorganization by which, if a company has a large amount of cash on hand, it could be distributed without any tax . . . and . . . evade to a large measure not only the corporation tax, but in a great many instances the personal income tax.[251]

Nevertheless, the Revenue Acts of 1928 and 1932[252] basically embedded these same rules in Sections 112 and 113.

In 1933, a special Ways and Means Subcommittee recommended that the nonrecognition provisions relating to reorganizations be abolished.[253] The reasons for the recommendation were twofold: closing "one of the most prevalent methods of tax avoidance," and "simplify[ing] the income tax law."[254] Nevertheless, as usual in the case of substantial tax reforms, timing was crucial. The Ways and Means Committee rejected the report, basing its decision on the economic realities of the time.[255] The Committee concluded that the abolition of the exchange and reorganization provisions might result in a revenue loss, and that, in any case, most reorganizations showed

251. 65 CONG. REC. 2,429 (1924), *reprinted in* SEIDMAN, *supra* note 222, at 697–98.

252. The 1932 Act did reduce the threshold for exchanged basis treatment in Subsection 113(a)(7) to 50%. I.R.C. § 113(a)(7) (1932), *reprinted in* SEIDMAN *supra* note 222, at 454. Additionally, Subsection 112(k) was introduced to eliminate tax avoidance through transfers to foreign corporations. *Id.* § 112(k) (1932), *reprinted in* SEIDMAN, *supra* note 222, at 452.

253. H.R. REP. NO. 73, at 8–9 (Dec. 4, 1933), *reprinted in* SEIDMAN, *supra* note 222, at 332. The subcommittee added the acknowledgement that, in special cases, exchanges of stock, for instance, may result in undue hardship on the taxpayers to pay the tax currently, since no actual cash was received by them upon the exchange. In these special cases, the subcommittee recommended that the Treasury be granted authority to extend the time for payment up to two years. The background for this report had been the failure of the legislation to implement the alleged policy in the area of corporate reorganizations. As Paul stated, "Elaborately drawn provisions were found to be inadequate and ambiguous, and to the extent that they were clear, they were exploited to the limit by diligent tax avoiders." PAUL, *supra* note 211, at 37. For more critique, see *supra* Part II.B.

254. H.R. REP. NO. 73, at 8–9 (Dec. 4, 1933), *reprinted in* SEIDMAN, *supra* note 222, at 332.

255. H.R. REP. NO. 73-704, at 13–14 (1933), *reprinted in* SEIDMAN, *supra* note 222, at 338–39.

a loss at the time.[256] It concluded, therefore, that "the wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely."[257] The committee referred to the courts as safeguards of the "right" policy. This decision doomed the reorganization rules to live on as the convoluted and complex regime we have today. Legislators have consistently chosen to add patches of anti-avoidance rules rather than re-evaluate the regime itself.

The Revenue Act of 1934[258] limited the definition of a reorganization in Subsection 112(g) to what we know today as types "A," "B," "C," "D," "E," and "F" reorganizations, allegedly establishing a closer connection to corporate law by insisting on a statutory merger and at least eighty percent control.[259] The Act also added the "solely for all or part of its voting stock" requirement to the type "B" and type "C" reorganizations.[260] The substituted basis rule was enforced in Subsection 113(a)(6).[261] The type "G" bankruptcy reorganization was added later and was subjected to the "reorganization" definition by the Revenue Act of 1943, completing the set of reorganizations presently in use.[262]

The 1930s brought an additional layer of rules to the taxation of corporate reorganizations. Another wave of important cases established judicial doctrines, requiring taxpayers to satisfy some additional extra-statutory principles. The first doctrine was the "business purpose" requirement. In the seminal case of *Gregory v. Helvering*,[263] the Supreme Court required, in addition to compliance with the language of the statute, that a transaction must also serve a

256. *Id.*

257. *Id.*

258. The Revenue Act of 1938, and the Internal Revenue Code of 1939, without much change to the Revenue Act of 1934, also limited this definition.

259. This change upgraded the previous requirement from a simple "majority" to one of 80%. I.R.C. § 112(g) (1934), *reprinted in* SEIDMAN, *supra* note 222, at 341–42. The Revenue Act of 1936 amended Subsection 112(h) in clarification of the "control" definition to at least 80% of the "total combined voting power," rather than just the "voting stock," supposedly not changing the law by doing so. *Id.* § 112(h) (1936), *reprinted in* SEIDMAN, *supra* note 222, at 243; 80 CONG. REC. 8,799 (1936), *reprinted in* SEIDMAN, *supra* note 222, at 243.

260. I.R.C. § 112(g) (1934), *reprinted in* SEIDMAN, *supra* note 222, at 341–42.

261. *Id.* § 113(a)(6) (1934), *reprinted in* SEIDMAN, *supra* note 222, at 346.

262. Section 121(a) of the 1943 Act added Section 112(b)(10) to the Code. *Id.* § 112(b)(10) (1943), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS: 1953–1939, at 1551–52 (1953). In this Article, I do not generally refer to this type "G" reorganization, for simplicity.

263. 293 U.S. 465, 469 (1935).

"business or corporate purpose" in order to claim "reorganization" treatment. This requirement has long been embodied in the applicable regulations[264] and has since been consistently followed by the courts and the Internal Revenue Service.

The second judicial doctrine, the "continuity of business enterprise" (COBE),[265] requires that enough of the target corporation's business must be carried on by the acquiring corporation. This doctrine has also been incorporated into the regulations and has been followed, although somewhat inconsistently.[266] The COBE requirement emphasizes the policy that the reorganization of a business should not trigger recognition and current taxation of income because of a mere formal change in the corporate structure, so long as the business itself (and its value) remains essentially unchanged.

The third, and probably most influential doctrine, is the "continuity of shareholder (proprietary) interest" (COSI). It complements COBE, from the perspective of the shareholders' proprietary interests, in supporting the same policy that recognition of income and its current taxation should not be triggered due to mere formal changes in the corporate structure of an investment. In particular, this should not be the case where the same investors hold the same investment, with no changes to the nature of that investment. The purpose of this requirement has been to distinguish "sales," disguised in the statutory language of the reorganization provisions, from bona fide transactions, serving merely as readjustments to the corporate form of the investment.[267]

264. Treas. Reg. § 1.368-1(b)–(c) (as amended in 2001).

265. This doctrine has been applied unevenly throughout the years—it was abandoned for some time, and then it reemerged recently in the form of a final regulation. *See* John T. Sapienza, *Tax Considerations in Corporate Reorganizations and Mergers*, 60 NW. U. L. REV. 765, 782 (1965–1966).

266. *Compare* Rev. Rul. 56-330, 1956-2 C.B. 204, at 205–06 (asserting that the purpose of the reorganization provisions is to exempt from the general recognition rule certain specified exchanges incidental to readjustments of corporate structures, and only readjustments of continuing interests in property under modified corporate forms, and declaring that this was an established policy of the IRS), *with* Rev. Rul. 63-29, 1963-1 C.B. 77 (directly revoking Rev. Rul. 56-330). Currently, the doctrine is reinforced in Treas. Reg. § 1.368-1(d) (as amended 2001).

267. Le Tulle v. Scofield, 308 U.S. 415 (1940); Helvering v. Minn. Tea Co., 296 U.S. 378 (1935); Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462 (1933); Cortland Specialty Co. v. Comm'r, 60 F.2d 937 (2d Cir. 1932). The requirement was incorporated in the regulations, first in Treas. Reg. 103, § 19.112(g) (1940). *See* PAUL, *supra* note 211, at 92 n.303. Presently it is in Treas. Reg. § 1.368-1(e) (as amended 2001).

In addition to these three requirements, the courts have applied several other judicial techniques in the interpretation of the corporate reorganization provisions. The most quoted is the "Step-Transaction" doctrine,[268] an extension of the substance-over-form idea, which is the actual conceptual basis for the reorganization rules themselves—nonrecognition allowed to formal changes that do not amount to substantive changes justifying recognition and current taxation of income.

The 1939 Act (and Internal Revenue Code) added the rule that, in general, assumption of liabilities, or receipt of an asset subject to a liability in a reorganization, should not be considered as an income-recognition event.[269] The rationale of this amendment follows that of the general nonrecognition rules for reorganizations, which is that no "real" realization has occurred, that taxation will cause undue hardship on taxpayers since they received no cash in the transaction, and, oddly, that it is the taxpayers' expectations that there will be no recognition involved in these transactions.[270] Interestingly, the legislative history indicates that the House was concerned about restructuring the reorganization provisions based on "uniform equitable rules," emphasizing the primacy of the concept that no recognition is required in corporate noncash-out transactions.[271] Fairness, rather than efficiency or administrative ease, seemed to be the rhetorical engine behind the 1939 legislature.[272]

The 1951 Act formally reintroduced spin-off transactions to the list of potential candidates for nonrecognition.[273] The legislators

268. Bassick v. Comm'r, 85 F.2d 8, 10 (2d Cir. 1936); Am. Bantam Car Co. v. Comm'r, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949).

269. I.R.C. § 213(a), (c) (1939), *amending* § 112(b)(5), (k) (1938), *reprinted in* SEIDMAN, *supra* note 262, at 1539, 1593. The change was made in view of *United States v. Hendler*, 303 U.S. 564 (1938), which was interpreted to the effect of current recognition of gain in a reorganization to the extent of the assumption of liabilities involved; the Ways and Means Committee assumed that *Hendler* nullified the reorganization provisions. H.R. REP. NO. 76-855, at 4–5 (1939), *reprinted in* SEIDMAN, *supra* note 262, at 1593.

270. H.R. REP NO. 76-855, at 19–20 (1939), *reprinted in* SEIDMAN, *supra* note 262, at 1539–40.

271. *Id.*

272. The trigger for the legislation was, of course, the *Hendler* case. *See supra* note 269.

273. Originally permitted to be accomplished tax-free by the Revenue Act of 1924, they were repealed by the Revenue Act of 1934. Section 317(a) of the 1951 Act introduced I.R.C. § 112(6)(11). S. REP. NO. 82-781, at 57–58 (1951), *reprinted in* SEIDMAN, *supra* note 262, at 1556. Congress feared that Mrs. Gregory might win her case, as she did at the Board of Tax Appeals (now the U.S. Tax Court). Evelyn F. Gregory, 27 B.T.A. 223, 225 (1932). *See* BITTKER & EUSTICE, *supra* note 8, ¶ 13.02–.03.

thought that impeding such transactions (by not allowing them nonrecognition treatment) would be economically unsound, deviating from the traditional fairness-based language to a more efficiency-based rationalization.[274] The Internal Revenue Code of 1954 basically rearranged the statutory scheme to the format we face today, presenting in Subsection 368(a) a conclusive definition of six types of transactions that qualify as reorganizations, namely types "A," "B," "C," "D," "E," and "F" reorganizations. Subsections 354(a) and 361(a) provided the operative rules of nonrecognition to the shareholders and corporations, respectively, party to the reorganization.[275] The code also relaxed the requirements of the type "C" reorganization, allowing for twenty percent "boot" leeway, similar to current law.[276] Importantly, this code enacted the elaborate provisions and limitations for tax attribute carryover.[277]

Interestingly, the Ways and Means Committee had proposed to distinguish between publicly traded and closely held corporations, arguing that the former, having more separate existence than the latter, do not tend to engage in reorganizations merely to secure tax advantages for their shareholders.[278] This proposal, even though it came from an anti-avoidance background, attempted to create, through a semiformal test, a more substantive rule. The Senate, however, rejected the proposal.[279]

The 1954 code also added Subsection 368(a)(2)(C), allowing use of parent stock in type "C" reorganizations and permitting a drop down (contribution) of assets acquired in a type "C" reorganization to a controlled subsidiary immediately after the original exchange (the receipt of these assets for stock of the exchanging (parent) corporation) without gain recognition. This was the first "triangular reorganization" provision, and similar additions

274. S. REP. NO. 82-781, at 57–58 (1951), *reprinted in* SEIDMAN, *supra* note 262, at 1556. The spin-off provisions are technically beyond the scope of this Article, but I chose to include them here because they were part of the same body of legislation as the reorganization provisions, they were conditioned on a "good" reorganization, and they indicate the mindset and rationale of the legislature.

275. Including the basic repeal of the *Groman-Bashford* narrow interpretation of "a party to the reorganization," to allow for an acquiring corporation to transfer stock of its parent in the reorganization. *See* H.R. REP. NO. 83-1227, at 40 (1954); S. REP. NO. 83-1622, at 52 (1954).

276. *See* S. REP. NO. 83-1622, at 52 (1954).

277. The then, and current I.R.C. §§ 381, 382 (2000).

278. H.R. REP. NO. 83-1227, at 39 (1954).

279. S. REP. NO. 83-1622, at 51 (1954).

were subsequently added to the tax code: the extension of the Subsection 368(a)(2)(C) treatment to type "B" reorganizations in 1964; the addition of Subsection 368(a)(2)(D), addressing forward triangular mergers, in 1968; and the addition of Subsection 368(a)(2)(E), addressing the reverse triangular merger, in 1971. These additions intentionally expanded the scope of nonrecognition to transactions economically similar to other reorganizations, providing corporate groups with further flexibility and easier paths to circumvent the original limitations on the nonrecognition tax benefit.[280]

In the 1970s, legislators further developed anti-abuse rules aimed at denying deductions for artificial losses realized by investment companies,[281] again stressing their intention to allow tax benefits relating to reorganizations only in certain situations, and only when active business is involved. In 1980, the type "G" bankruptcy reorganization was enacted.[282] This decade also saw other slight modifications to the scope of certain reorganizations and their application to special entities.[283] In the 1990s, most of the legislative activity surrounded divisive reorganizations, which are beyond my scope here. Throughout this period no explicit discussion of the policy behind the reorganization provisions is evident.

The important Tax Reform Act of 1986 did add a significant new piece to the puzzle, although indirectly, with the abolishment of the "General Utilities" doctrine. This doctrine had allowed taxpayers, in certain cases, to make the tax deferral in M&A transactions permanent, avoiding at least one level of corporate tax. The 1986 Act generally confined the application of tax-free reorganizations to pure tax-deferral transactions, barring an easy path

280. These rules allow, for example, a foreign corporation to acquire, tax free, a domestic corporation, by organizing a domestic subsidiary that actually affects the acquisition/merger. The consideration to the target shareholder remains the stock of the parent, i.e., the foreign company.

281. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

282. Bankruptcy Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389, *clarified in* Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365. This reorganization type is, of course, beyond my scope.

283. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

to tax avoidance and preserving the integrity of the carried-over asset basis as the price for such deferral.

It is evident that the reorganization provisions and their benefits are intended to apply only to transactions where either the core ownership group or the core business, or both, remain substantially the same except for a formal change justified by business reasons. This is also the basic rationale behind their legislation, as apparent from the famous *Bazley* quote.[284] This justification, originally supported by perceptions of fairness, is the cornerstone for allowing reorganizations to maintain their role as necessary exceptions to the fundamental (though vague and sometimes unsatisfactory) realization basis of the income tax system. In the background, one can perceive that reorganizations are also justified by efficiency reasons, since they allow businesses flexibility without prohibitive tax costs to mere technical changes. This scheme has not been effectively challenged over the years. In the next section, I elaborate on some of the more serious critique attempts.

II. MAJOR HISTORICAL CRITIQUES OF THE REORGANIZATION PROVISIONS

The complexity of the American tax system, the tax code, and the reorganization provisions in particular is notorious. Many proposals for changes to these provisions have been presented, primarily with the goal of shutting down various planning techniques.[285] However, only a handful of analytical work has been done to evaluate the essence of the rules with the goal of fundamental changes, or complete repeal, despite these provisions' apparent lack of theoretical support. As observed by Professor Paul in 1940, "The statute imposed objective tests in defining reorganizations; these tests furnished Euclidian formulae as to what should be done, but said nothing about why."[286] The sole serious proposal to repeal the reorganization provisions occurred in 1933. As mentioned previously, a special Ways and Means Subcommittee recommended abolition of the provisions, purely on simplicity and anti-avoidance grounds.[287] The subcommittee acknowledged that the

284. *See supra* text accompanying note 8.

285. *See, e.g.*, BITTKER & EUSTICE, *supra* note 8, ¶ 12.01[5].

286. PAUL, *supra* note 211, at 121.

287. H.R. REP. NO. 73, at 8–9 (Dec. 4, 1933), *reprinted in* SEIDMAN, *supra* note 222, at 332. The subcommittee added the acknowledgement that, in special cases, exchanges of stock,

effect of these provisions was merely deferral of the payment of the tax and mentioned three reasons for the existence of the (then) current regime: (1) the exchange and reorganization provisions prevent much of the uncertainty and litigation under prior law (regarding the question of whether a realization event occurred or not); (2) the discussed transactions are merely normal business adjustments and the profits from them are merely paper profits that should be exempt in order to not interfere with the normal course of business; and (3) it prevents taxpayers from taking colorable losses. Nevertheless, the subcommittee concluded that the experience of the administration was that the abuse and avoidance opportunities far outweigh the advantages above.[288] In response to the first reason mentioned above, the report relies on the fact that the law was complex, uncertain, and even harder to administrate than prior law. The report accepted the second argument as having some merit, but repeated its determination that the abuse outweighs the advantages. Structurally, the subcommittee commented that the "system is unsound which does not tax gains in the year in which realized,"[289] concluding with the estimation that these provisions result in a considerable loss of revenue.[290] The committee itself rejected the report, concluding that the repeal might result in a revenue loss and preferring an opportunistic hole-plugging policy.

In the next seventy years, only a handful of articles attempted to fundamentally criticize the reorganizations regime. In 1938, Milton Sandberg explicitly stated that the tax treatment of reorganizations amounts to a subsidy of such transactions, adding that "the most striking thing of all is that no one can satisfactorily explain why they were ever enacted or why they have remained."[291] He realized that there is no stated explanation for subsidizing these transactions and not other transactions, and that there is not even an unstated reason

for instance, may result in undue hardship on the taxpayers to pay the tax currently, since no actual cash was received by them upon the exchange. In these special cases the subcommittee recommended that the Treasury be granted authority to extend the time for payment up to two years. The background for this report had been the failure of the legislation to implement the alleged policy in the area of corporate reorganizations.

288. H.R. REP. NO. 73, at 37–42 (Dec. 4, 1933), *reprinted in* SEIDMAN, *supra* note 222, at 334.

289. *Id.* at 8–9, *reprinted in* SEIDMAN, *supra* note 222, at 332.

290. *Id.* at 37–42, *reprinted in* SEIDMAN, *supra* note 222, at 335.

291. Sandberg, *supra* note 11, at 98.

that could plausibly support this subsidy.[292] The most quoted article in this line was written by Jerome R. Hellerstein after the enactment of the Internal Revenue Code of 1954, proposing to eliminate the reorganization provisions from the code.[293] Hellerstein identified the original reasons for reorganizations: the merely-formal-changes reason, the hardship-to-taxpayers reason, and the administrative and taxpayers' convenience reason. He also identified the implied efficiency justification—that reorganizations are necessary in order to not discourage ordinary adjustments and to allow healthy expansion of the economy.[294] He then argued that none of these reasons could hold fast, and that "Congress has not seriously considered the wisdom of granting nonrecognition to reorganization exchanges"[295] in light of the 1933 report and all the preparatory work done prior to the enactment of the "new" 1954 code. The best proof is in the first and primary justification for reorganization preferences, since they actually applied (and continue to apply today) not only to clear changes in form, but also to a variety of transactions where "substantial changes in position take place."[296] Nonrecognition treatment is normally (as it should be) a rare exception in the tax law, and narrowly circumscribed. Amazingly, that has not been the case where reorganizations are involved, where nonrecognition was and is granted in a most sweeping manner, affecting a large number of transactions and substantial amounts of gains and losses.[297] The result of this extraordinary treatment of reorganizations is "favoritism and discrimination" (basically an equitable problem), and it lengthens the interval between wealth increases and taxation, i.e., it extends the deviation of realization-based income tax from the Schanz-Haig-Simons definition of income.[298] Hellerstein also rejects the hardship and convenience reasons, since these are just difficulties that could be easily solved. Regarding the implied efficiency justification to reorganizations, he shows that no evidence has been

292. *Id.* at 101–02.

293. Hellerstein, *supra* note 9, at 254. Interestingly, the House Bill of 1954 unsuccessfully attempted to limit the scope of transactions qualifying for the preferential nonrecognition treatment. *See* H.R. 8300, 83d Cong., § 359(b)–(d) (1954); Crockett, *supra* note 50, at 9–10.

294. Hellerstein, *supra* note 9, at 276.

295. *Id.* at 259 n.22.

296. *Id.* at 262.

297. *Id.* at 265–66.

298. *Id.* at 271.

presented in its support.[299] Furthermore, he relies on economic studies of the mergers of the first half of the century to show an increase in tax-motivated mergers, using stock compensation instead of cash. Nevertheless, taxable cash transactions were still significant, and tax motives were generally affecting the form of the transaction rather than the decision of whether to merge. He concluded that there is no evidence that reorganizations are actually efficiency-increasing, nor is there evidence to support the notion that their elimination would "impose a significant barrier to the expansion or health of our economy."[300] Congress ignored all of these arguments and kept (in the 1954 code) things as they were, following the uneducated path of its 1934 predecessor. I chose to discuss Hellerstein's arguments at length, since, unfortunately, they are as relevant today as they were 45 years ago.

In 1976, Professor Crockett reviewed once again the original and other justifications for the tax subsidy to reorganizations, concluding that reorganizations are "no longer necessarily beneficial to the economy,"[301] referring back to Sandberg and Hellerstein,[302] and further determining that reorganizations do not serve the "goals of an equitable tax structure."[303] In 1985, Professor Posin made yet another contribution, focusing on the notorious complexity of the reorganization provisions, conservatively suggesting caution, in spite of the shortcomings of a "known" system.[304] Unfortunately, he supported his suggestion only with the observation that such an overhaul may result in making the system worse, without actual analysis or specific improvement proposals.[305] In 1989, Professor Coven reached the conclusion that "the need to quite generally overhaul the taxation of corporate acquisitions is entirely evident."[306] He ably argued that such overhaul must include a comprehensive solution to all corporate acquisitions, specifically promoting a mandatory carryover basis system for all such transactions.[307]

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299. *Id.* at 277.
300. *Id.* at 279.
301. Crockett, *supra* note 50, at 26.
302. *Id.*
303. *Id.* at 29.
304. Posin, *supra* note 203, at 1407–08.
305. *Id.*
306. Coven, *supra* note 10, at 203.
307. *Id.*

One would expect that this visible criticism,[308] despite its relative thinness throughout the years, would be more influential, or, at least, ignite a lively debate. This is a major part of the tax law, and it is criticized as intellectually unfounded. However, that has not been the case, and the critique remains basically unanswered.[309]

308. Most of the literature appeared in leading legal publications. *See supra* notes 291–300, 305–06.

309. I found one interesting response to Hellerstein. John Dane Jr., of the Department of Corporations and Taxation of the Commonwealth of Massachusetts, argued against Hellerstein's criticism of the reorganization provisions that it is not fair to tax a taxpayer on a gain from a nonvoluntary transaction. John Dane Jr., *The Case for Nonrecognition of Gain in Reorganization Exchanges,* TAXES, Apr. 1958, at 244. Mr. Dane's experience in Massachusetts, where the law taxed reorganizations, supported, in his opinion, the Federal treatment. He admitted that such unfairness can be remedied, but seemed to ignore this in his conclusion, failing to support it with other explanations or empirical evidence from his experience. This criticism is interesting, since it may inspire further study of parallel systems that do tax reorganizations. I found no such existing study.