REPORT #614

TAX SECTION

New York State Bar Association

Report on the Provisions of the 1989 Budget Act
Relating to Corporate Mergers and Acquisitions

June 8, 1989

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TAX SECTION

New York State Bar Association

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June 9, 1989

The Honorable Mario R. Cuomo
Governor, State of New York
The Capitol
Albany, New York 12224

Re: 1989 Budget Act Provisions Relating to <u>Corporate Mergers and Acquisitions</u>

Dear Governor Cuomo:

Further to the letter sent to you on April 14, 1989 regarding the serious defects in sections 342 through 361 of the Budget Act, enclosed is a report listing the major defects that we believe are contained in the statute as enacted.

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4324r

cc: Evan A. Davis, Esq.

Duplicate letters to:

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Tax Report #614

June 8, 1989

New York State Bar Association, Tax Section

Report on the Provisions of the 1989 Budget Act

Relating to Corporate Mergers and Acquisitions*

I. Introduction and Summary of Conclusions.

On April 19, 1989, Governor Cuomo signed into law the Budget Act, Chapter 61 of the Laws of 1989 (the "Act"). Sections 342 through 361 of the Act include new rules ("LBO Rules") that impose State, and to a lesser degree New York City, tax costs on taxpayers participating in certain corporate acquisitions, mergers or consolidations.

In a letter dated April 14, 1989 to Governor Cuomo and various legislative leaders, the Chair of the Tax Section, writing on behalf of the officers of the Tax Section, opposed the enactment of the LBO Rules (which were included in the then pending budget bill) without an opportunity for public comment. The letter noted that the LBO Rules were replete with technical deficiencies.

* The principal drafters of the report were James M. Peaslee and Elizabeth Whalen. Helpful comments were received from William Burke, Dale Collinson, Paul Comeau, John Corry, Peter Faber, Arthur Feder, Gordon Henderson, Carolyn Ichel, Robert Jacobs, James Locke, Richard Reinhold, Michael Schler and Ralph Winger.

This report outlines the principal problems we see with the LBO Rules as enacted. We believe the rules suffer from major defects. In our view, the rules:

--are arbitrary in that they apply to many transactions having nothing to do with an LBO or takeover and yet do not extend to cases where they would be expected to apply;

--are not directed, as they should be, at activity in New York State since they are not limited to transactions that affect businesses, or result in the loss of tax revenues, in the State;

--favor large corporations over smaller corporations, and highly leveraged corporations over more conventionally capitalized companies, as acquirors;

--in some cases, reduce rather than increase taxes by increasing the deductions allowable for interest on acquisition debt;

and deviate from desirable conformity between the federal and State tax systems in a difficult area, thereby imposing a significant cost in terms of increased administrative burdens and complexity.

In addition, the principal objectives of the LBO Rules limiting carryovers of losses and credits are already met under current law (in the case of losses) or could be achieved through much simpler means (in the case of credits). Sections 382 and 383

of the Internal Revenue Code of 1986 (the "Code"), as amended in 1986, severely limit the use of carryovers and credits following a leveraged acquisition. Section 382 already applies at the State level, and section 383 could be extended to State credits through a simple amendment. We would not oppose such an amendment.

If the LBO Rules are preserved in anything like their present form, a substantial technical overhaul will be required. As enacted, the LBO rules produce results that in many cases cannot have been intended by their drafters. Fixing the LBO Rules will be a major undertaking, and will almost certainly result in an even more complex statutory scheme. The concepts involved in the LBO Rules are difficult, and our experience with section 382 of the Code and other Code provisions relating to corporate acquisitions leads us to believe that simple solutions will not be found.

If the rules are as complex as we expect, the Department of Taxation and Finance will be required to devote substantial resources, at the policy and audit levels, to the interpretation and implementation of the rules. Further, private practitioners will need to devote considerable time to mastering the rules in order to advise-clients, particularly if the rules continue to apply, as they do now, outside of the LBO and takeover areas.

Without commenting on the wisdom of the social policy of curbing corporate mergers and acquisitions, we do not believe that the attenuated effect the LBO Rules will have in furthering that policy could possibly be worth their cost to New York State in terms of administrative burdens and complexity. Further, the Tax Section is generally opposed to the use of the State tax system to promote social policies that are largely unrelated to the collection of State revenues. Accordingly, subject to the comment above relating to an extension of section 383, we recommend that the LBO Rules be repealed.

The report begins with a brief summary of the LBO Rules. The summary is followed by general and then more detailed comments. For ease of presentation, the detailed comments primarily take the form of questions and examples.

II. Summary of LBO Rules.

The substantive LBO Rules are for the most part conditioned on the occurrence of a “corporate merger,” “corporate consolidation” (generally, any state law merger or consolidation) or “corporate acquisition” (generally, an acquisition of stock by a person that results in that person increasing his voting stock interest in a corporation from 50 percent or less to more

than 50 percent). (Section 208.13-.15*) Apparently, that an acquisition is accomplished through a merger or consolidation does not prevent it from being a "corporate acquisition" if it otherwise meets the definition of the term.

"Excluded transactions" are carved out of the definitions of corporate merger, consolidation and acquisition. (Section 210.16) Such transactions include mergers, consolidations or acquisitions involving corporations that are members of an affiliated group. For this purpose, "affiliated group" has the same meaning as in section 1504 of the Code, except that (i) the common parent may be <u>any</u> person as defined in section 7701(a)(1) of the Code (which includes an individual or partnership) and (ii) references in the Code definition to "at least eighty percent" are replaced with "more than fifty percent." Certain acquisitions by trusts or partnerships controlled by, or trusts for the benefit of, employees (which apparently need not be ESOPs or other qualified plans) and redemptions to pay estate taxes are also excluded transactions.

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* Except where otherwise indicated, all section references herein are to the NYS Tax Law, as amended by the Act.

The "acquiring person" in a corporate merger or consolidation is the constituent corporation whose stockholders, after the merger or consolidation, own the largest proportion of the total voting power of the surviving corporation. All other constituent corporations are "target corporations." (Section 208.13,.14) In the case of a corporate acquisition, the "target" is always the corporation whose stock is acquired. (Section 208.15)

Certain, but not all, of the tax limitations apply to a corporate acquisition, merger or consolidation only if a "leverage test" is also met. (Sections 208.17 and .18, and 208.9(b)(6-a)(B)) This test generally requires that all three of the following factors be present: (i) the combined average debt-to-equity ratio of the acquiring person and the target corporation in the year of the acquisition must exceed by more than 100 percent that same ratio for the prior year; (ii) the combined average debt-to-assets ratio for the acquisition year must exceed that ratio for the prior year by more than 60 percent; and (iii) the interest paid or accrued by the acquiring person (or, in the case of a corporate merger or consolidation, the surviving or consolidated corporation) during the acquisition year, whether or not the interest expense relates to an acquisition or merger, must exceed $1 million. For these purposes, if the acquiring person is a member of an affiliated

group, all members of the group are generally treated in the aggregate as the acquiring person.

The substantive limitations imposed by the LBO Rules relate to tax credits, net operating loss ("NOL") carryovers, interest expense and the definition of subsidiary capital.

First, the Act disallows all carryovers of research and development, employee, and investment tax credits ("ITCs"), of the target corporation in a corporate merger, consolidation or acquisition to the year of the acquisition (including the pre-acquisition portion of the year) or subsequent years, regardless of whether the leverage test is met. (Sections 210.12(e)(2),(3); 210.12-A(c)(2),(3); 210.12-B(C)(2),(3); 210.18(e)(2),(3)) If, in addition, the leverage test is met, a target corporation is deemed to dispose of all of its assets for which ITC was claimed, resulting in recapture of the ITC and possibly other consequences. (Sections 210.12(g)(9)-(11); 210.18(f)(5)-(7)) Further, if the leverage test is met, the Act disallows all NOL carryovers of the target corporation attributable to losses in the year in which the acquisition occurs (including the post-acquisition portion of the year) and all prior years. (Section 208.9(f)(2-a)-(2-c))

The Act also disallows 5 percent of the interest expense deduction of the acquiring person in a corporate merger, consolidation or acquisition for the year of the acquisition and the next three following years, subject to a limit based on the cost of the target, where the leverage test is met and the interest in the target that is acquired exceeds $5 million. (Section 208.9(b)(6-a)) The disallowance rule also applies to interest expense of affiliates of the acquiring person (generally including the target corporation). (Section 208.9(b)(6-a)(4)) The disallowance rule may also be triggered by certain acquisitions of assets of another corporation valued in excess of $5 million that are not subject to any of the Act's other provisions. (Section 208.9(b)(6-a)(2))

Finally, where a corporate acquisition occurs and, within eighteen months of the acquisition, dispositions of target stock cause the acquiring person's interest to drop to 50% or less (or sales or other dispositions of assets by the target corporation, outside of the normal course of its business, result in the target holding 50 percent or less of the assets that it owned on the acquisition date), stock in the target is retroactively reclassified as investment capital. (Sections 208.4(b),(c); 208.6) Furthermore, dividends on such stock are not eligible for the 50 percent exclusion normally applicable to

dividends on stock held as a portfolio investment. (Section 208.9(a)(2)) This reclassification of target stock results in the taxation of amounts previously excluded from the acquiring person's entire net income as income from subsidiary capital. (Section 208.9(b)(12)-(14)) The rule does not affect the taxation of the target corporation with respect to dispositions of its assets.

III. General Comments.

As explained further in Part IV of this report, the LBO Rules have the following major defects (references below to examples are to the examples in Part IV):

1. The rules are arbitrary, in that they will affect transactions (and borrowings) that are not connected with a leveraged buyout or takeover. For example, a corporation could suffer the disallowance of a portion of its interest expense if, in a given year, it borrowed to buy a factory and, in addition, redeemed the stock of a minority shareholder, with the result that a long-time 49 percent shareholder increased his ownership to above 50 percent. To give another example, the rules would cause the loss of ITC carryovers of a corporation if the majority stockholder dies (see Example 14) or if one of two equal shareholders of a corporation buys the stock of the other.

2. On the other hand, the rules do not cover cases where they might be expected to apply. For example, companies that are heavily leveraged -- such as corporate raiders with a history of participating in leveraged acquisitions, or a bank or finance company -- enjoy an effective exemption from most of the Act (see Part IV.9. below). Thus, they fare better under the Act than a conventional business corporation that wishes to acquire another corporation as part of a strategy to significantly expand its operations.

3. The New York State policy that is advanced by the LBO Rules is unclear. The rules are not limited to acquisitions of businesses located within the State. Indeed, it appears that the interest disallowance rule may apply to a New York taxpayer as a result of an acquisition having no connection with New York (see Part IV.16). Also, the rules do not appear to be concerned with the erosion of the State tax base as a result of the substitution of corporate debt for equity, since the leverage test does not depend on an increase in debt that gives rise to interest deductions in New York. See Part IV.9.

4. The LBO Rules favor large corporations over smaller corporations as acquirors (see Example 18). In many cases, if two corporations bid for the the smaller of the two would be subject to the Act while the larger one would not be.

6. Under certain circumstances, the LBO Rules change the classification of stock of target corporations from subsidiary capital to investment capital. Although the apparent purpose of this change is to subject income from the stock to tax, it can also have the effect of increasing the percentage of interest on debt attributable to target corporation stock that can be deducted from 0% to 95% (giving effect to the 5% disallowance rule). More generally, the current law rule disallowing interest deductions on debt attributable to subsidiary capital raises a question as to the significance of the 5% interest disallowance rule.

7. The Tax Section has always favored conformity to the extent possible between the State and federal income tax systems. The LBO Rules represent a significant departure from such conformity.

We have one final general comment on the LBO Rules. The principal objectives of the rules limiting carryovers of NOLs and credits are already met under current law, in the case of losses, or could be achieved more simply in the case of credits. Sections 382 and 383 of the Code, as amended in 1986, limit the use of carryovers of losses (section 382) and credits (section 383) of

an acquired corporation.* In particular, they allow losses and credits to be used only to offset the tax on a hypothetical amount of income of the corporation.

This income is computed by multiplying the value of the equity of the acquired corporation by a long-term tax exempt bond rate (for May of 1989, 7.39%). The equity value of a corporation acquired in a leveraged transaction is reduced by the amount of acquisition debt (assuming the acquired corporation is expected to be the source of funds for repayment of the debt).** Thus, sections 382 and 383 severely reduce the value of the carryovers of tax attributes of a corporation that is acquired in a leveraged transaction.

For example, if P acquired T in May of 1989 for $100 million, which was financed with $10 million of equity and $90 million of debt, the maximum amount of NOL carryovers of T that could be used to offset income in any post-acquisition year would

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* Technically, the sections apply to a corporation that experiences an "ownership change," which is generally a more than 50 percentage point increase in stock ownership by one or more 5-percent shareholders over a three-year period.

** Section 382(e)(2) ("value" determined after giving effect to corporate contractions).

be $739,000 (7.39% of $10 million). Thus, if T had NOL carryovers of $10 million, those NOLs would be spread over a period of 14 years. If the annual section 382 limitation prevents NOL carryovers from being used within the carryover period, then the benefit of those NOLs is completely lost.

The limitations of section 382 apply automatically to New York NOL carryovers because they are based on the carryovers allowed under the Code.* Carryovers of New York credits are computed independently of the federal credits and are not now subject to the principles of section 383. However, those principles could easily be extended to New York credits. If that were done, there would be little point in having an independent set of State limitations on carryovers of tax attributes.

The extraordinary effort required at the federal level to develop and implement limitations on carryovers, and the complexity of those limitations, strongly suggests that the State should not attempt to develop a parallel, but different, set of rules.

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* Section 208.9(f)(3); NYCRR § 3-8.2.

IV. Detailed Comments*

A. Definitions of Corporate Merger and Corporate Acquisition

Form Versus Substance/Step Transaction Doctrine

1. Consider the following:

> Example 1. A, B and C each contributes cash to P in exchange for one-third of P's common stock. P borrows funds from outside lenders and makes a tender offer to purchase the stock of T. In the tender, P acquires 95 percent of the stock of T and then immediately merges downstream into T, with T assuming the P debt. What is the result under the LBO Rules?

If the transaction were analyzed in the same way as for federal income tax purposes, P would be generally disregarded as a "transitory subsidiary" and the transaction would be characterized as a direct purchase of the stock of T by A, B and C. See Revenue Ruling 73-427, 1973-2 C.B. 301. Since P is ignored, the debt incurred by P and assumed by T would be considered to be incurred directly by T and used by it to redeem stock. Under this analysis, the transaction would not be a corporate acquisition of T since no one of A, B or C would

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* In the comments below, except where otherwise noted, P is an acquiring corporation, T is an acquired corporation (in the colloquial sense if not within the meaning of the statute) and A, B and C are equal one-third shareholders of P. All taxpayers are assumed to use the calendar year as their taxable year.

acquire a majority of the T stock.* Further, if P is truly disregarded, the P-T merger should also be disregarded so that no corporate merger would occur.

It would be possible to adopt a middle ground in applying the LBO Rules by (1) applying the federal step transaction approach in testing whether a corporate acquisition has occurred, but (2) reading the definition of corporate merger or consolidation to be met whenever the appropriate corporate law procedure is used. This approach would be analogous to the federal rule that recognizes the merger of a transitory subsidiary into a target as a "merger" for purposes of the definition of reorganization in sections 368(a)(1)(A) and (a)(2)(E) of the Code.

Finally, the LBO Rules could be applied giving effect to each formal step in the transaction. In that event, the purchase by P of the stock of T would be a corporate acquisition of T (since P would increase its ownership of T to above 50 percent) but the downstream merger of P into T would not be a corporate merger because P and T would be members of the same affiliated group.

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* It is assumed that the arrangement between A, B and C would not be considered a "partnership" within the meaning of the Code. If it were, that partnership would be a person acquiring a majority of the T stock.

How did the drafters intend that this very common transaction pattern be analyzed?

2. Step-transaction issues may also arise in a pure merger context, as follows:

> Example 2. (a) Three corporations, T1, T2 and T3, wish to combine through a merger. The relative sizes of their equity are 49, 31 and 20, respectively. How are the LBO rules applied if alternatively (1) all three are merged in a single transaction or (2) T2 and T3 are first merged and the survivor then merges into T1?
>
> (b) What would the result be if, in anticipation of a simultaneous merger of all three corporations, T1 borrowed and made a significant distribution to its shareholders (shrinking its equity to 30), or T2 received an equity contribution that increased its equity to 50? Would it matter if the contribution was made in exchange for voting preferred stock that is expected to be redeemed after the merger?
>
> (c) What if the former T1 shareholders received nonvoting stock of the surviving corporation which they have a right to convert to voting stock after one year? What about two years?

The Act provides that, in a merger, the constituent corporation whose stockholders have the greatest percentage of the voting power in the surviving corporation is deemed to be the acquiring corporation; all other participants are deemed to be target corporations. Thus, in the first transaction where the three corporations merge simultaneously, T1 would be the acquiring corporation and T2 and T3 the target corporations (assuming each corporation's relative equity contribution is reflected in its share of the voting power in the survivor). However, in the two-step merger alternative, assuming each step is recognized, the acquiring corporation would be T2 (because it would be the acquiror in the first merger, and the survivor of the first merger would have an equity of 51). Would a step-transaction analysis apply here to collapse the mergers? If the answer is “yes,” is that consistent with treating the merger of

the transitory corporation in Example (1) above as a corporate merger?

Similarly, the identity of the target corporation in a merger following a distribution by Tl, or capital contribution to T2, may depend on whether the distribution or contribution is integrated with the merger.

Finally, if the T1 shareholders receive nonvoting stock which is convertible into voting stock, T1 may or may not be the target corporation depending on whether the form of the stock as nonvoting stock is recognized or the conversion right is assumed to be exercised.

Part (c) of the example also illustrates the point that the identity of the target corporation depends on voting power rather than value, and voting power may not bear any relationship to value. The Code definition of affiliated group was changed in 1984 to address problems arising in part from undue reliance on a voting power test. Those amendments authorized the Treasury to issue regulations applying the new definition to various complex securities, but the project raises many difficult issues, and, after a five year delay, the regulations have still not been issued.

The identity of the target corporation in Example 2 could be affected by the presence of a holding company on top of one of the merger parties. See Example 13 below.

The mergers in Example 2, in contrast to an ordinary "acquisition," reflect a mere continuance of the merged corporations in different form. What is the policy reason for

completely denying the surviving corporation the tax benefits of any of the constituent corporations?

3. Example 3. A, B and C each own 25% of SI. The remaining stock is owned by the public. To eliminate the public shareholdings in SI, A, B and C form S2 by contributing to it their stock in SI, and then merge S2 into SI. In the merger, the shares held by the public are redeemed and the stock of S2 is exchanged for stock of SI. Is there a corporate merger and, if so, which corporation is the target, SI or S2?

Whether there is a corporate merger depends on how the step transaction doctrine is applied. (Compare Example (1) above.) Assuming that the step transaction doctrine is applied to prevent the acquisition of SI stock by S2 from being a corporate acquisition, but that the merger is still considered a corporate merger, which corporation is the target? If the merger is recognized, the target would appear to be SI, because the shareholders of S2 at the time of the merger (A, B and C) will own all of the stock of Si after the merger, and the shareholders of SI at the time of the merger (S2 and the public) will own none of that stock. Again, what is the policy reason for treating SI as a target in this example and adversely affecting its tax status?

4. Example 4. P has a subsidiary S. S merges with an unrelated corporation T, with T surviving. In the merger, P acquires more than 50 percent of the voting power of the T stock. Is T or S the target corporation?

The practical answer may be both. The transaction is a corporate merger in which T is the target corporation and S is considered the acquiring person. However, the transaction may also be a corporate acquisition in which T is the target corporation because the effect of the transaction is that P increases its ownership of T to more than 50 percent. The

definition of corporate acquisition does not by its terms exclude acquisitions through mergers or consolidations.

Ownership Attribution

5. As the examples below illustrate, a number of problems arise because of the failure to take account of the indirect ownership of stock.

> Example 5. P wishes to purchase all the stock of T. It does so by having its two subsidiaries, SI and S2, each purchase 50 percent of the stock of T. Is this transaction a corporate acquisition?

No. There is no rule that treats members of an affiliated group as a single acquiring person for purposes of the definition of corporate acquisition, and neither SI nor S2 acquires stock with more than 50 percent of the voting power of T.

6. The definition of an excluded transaction does not cover some obvious cases when an exception to the LBO Rules should be available:

> Example 6. A, B and C own stock in P. They transfer their stock to a partnership or corporation which they own in the same proportions as they owned the stock of P. Is either of these transactions a corporate acquisition?
>
> Both transactions are corporate acquisitions.
>
> Example 7. P forms S as a wholly-owned subsidiary and transfers assets to it. Does the formation of the subsidiary constitute a corporate acquisition of S by P?

Apparently, yes. The definition of an excluded transaction includes an acquisition where a corporation and the corporation acquiring it are members of an affiliated group (based on a more than 50 percent stock ownership link). When is

membership in an affiliated group tested? It cannot be tested immediately after an acquisition, since most acquired corporations will be members of the same affiliated group as the acquiring corporation immediately after the acquisition. On the other hand, if it is tested instead immediately before the acquisition, a corporate acquisition would occur in Example 7, since S would not be a member of the same affiliated group as P immediately before it was organized.

> Example 8. A, B and C own in equal proportions the stock of corporations S1 and S2. S1 and S2 are merged to achieve operating efficiencies (or for other business reasons).

This transaction is a corporate merger subject to the Act because A, B and C do not own enough stock of SI and S2 individually to qualify as a common parent. However, it is not clear whether SI or S2 is the target corporation. The test is based on the relative voting interest in the surviving corporation of the shareholders of each of the merger parties, and in this example, the shareholders of SI and S2 are identical and own the same voting interest (100 percent) in the surviving corporation.

> Example 9. P has a wholly owned subsidiary, S, which owns more than 50 percent of the voting stock of T but less than 50 percent of the value of T (i.e., T is not affiliated with S or P for purposes of the Act). S distributes its T shares to P as a dividend or S is liquidated or merged into P. Is there a corporate acquisition?

Yes. Because the P-S group does not own more than 50 percent of the value of T, P and T are not members of the same affiliated group and the transaction is not an excluded transaction. The

fact that P and S are members of the same affiliated group doesn't matter.

> Example 10. P, a holding company, owns all of the stock of a life insurance company, LI. If P merges downstream into LI (with P shareholders receiving LI stock in exchange for P stock), is there a corporate merger?

Yes. LI is not a member of the same affiliated group as P because it is a life insurance company, and thus the merger is not an excluded transaction. The exceptions in section 1504(b) of the Code (including the exception in paragraph (2) for life insurance companies) are not overridden in applying the definition of affiliated group.

> Example 11. P is a publicly held corporation. It is proposed to establish a new holding company, HC, which will own P. This is accomplished by organizing HC and then merging a newly established subsidiary of HC into P. For federal income tax purposes, the transaction would be analyzed as an exchange of P stock for the stock of HC. Is there a corporate merger or corporate acquisition, and if so, which corporation is the acquiring corporation?

The transaction will be a corporate acquisition (and possibly also a corporate merger) unless prior to the transaction P and HC are members of the same affiliated group because P owns the stock of HC. The need for P to own stock of HC seems to be a trap for the unwary.

> Example 12. D, an individual, owns 100% of the stock of T. D transfers the P stock to Partnership DE in which D has a 90% interest. Is the transfer a corporate acquisition by DE?

Yes. DE, as a partnership, is not a member of the affiliated group of T. The rule treating "any person as defined in section 7701(a)(1)" of the Code as a corporation applies only to the common parent.

> 7. Example 13. Return to Example 2 above, and assume that T3 (the smallest of the three merging corporations) has a holding company, HC. Suppose that T1 and T2 merge simultaneously into T3 and their shareholders received HC stock. Which corporation is the acquiring person?

The answer is apparently T3, even though it is the smallest of the three corporations, because its pre-merger shareholder (HC) owns all of the stock of T3 following the merger. There is no rule that looks through HC to its shareholders in applying the definition of target corporation.

Events Triggering a Corporate Acquisition.

8. A number of issues arise concerning the type of changes in the ownership of stock that will trigger a corporate acquisition. Note that a corporate acquisition can trigger the LBO Rules that depend on the leverage test if it occurs in the same year as an increase in debt, even if the two events are unrelated; there is no requirement that the corporate acquisition and increase in debt be connected. Consider the following examples:

> Example 14. P is a family owned corporation. More than 50 percent of the stock in terms of voting power is held by Mr. A, the family patriarch. A dies and leaves his stock to other family members. Is there a corporate acquisition? What if, instead, A transferred stock to a charity or family member as a gift, or to a former spouse incident to a divorce?

The transfer of the stock to A's estate is, apparently, a corporate acquisition since it is an acquisition "by purchase and/or otherwise" by a "person" as defined in section 7701(a)(1) of the Code, which includes an estate. There would apparently be a second corporate acquisition when the estate distributes the stock to the beneficiaries if any one beneficiary acquired more than 50 percent. There is also no exception for gifts or for transfers incident to a divorce.

Similarly, there would be a corporate acquisition if, prior to A's death and in order to allow the P business to continue, A's son purchased A's stock in P.

> Example 15. P redeems 10 percent of its outstanding stock, representing all of the P stock held by shareholder D. E, who has held a 46 percent stake in P for 3 0 years, experiences an increase in his interest to 51 percent as a result of the redemption. Is there a corporate acquisition?

Although an acquisition of stock which brings one person's voting power to above 50 percent is generally a precondition for a corporate acquisition, apparently no stock need be acquired in the redemption context because the definition of corporate acquisition refers to an acquisition "by purchase and/or otherwise (including redemption)". Assuming this is true, are there other situations where a corporate acquisition can occur without a physical acquisition of stock? The following example raises this question.

Example 16. D owns all of the common stock of P, which also has outstanding a class of nonvoting preferred stock owned by E. Dividends are not paid on the preferred, and as a result E acquires a right to elect more than half of the members of the P board of directors. D then agrees to make an additional capital contribution to P (in exchange for additional P common shares) to repay the accrued and unpaid dividends, with the result that he acquires additional shares of P stock and reacquires 100% of the voting power.

Does a corporate acquisition occur when, as a result of the nonpayment of the preferred stock dividend, E acquires more than 50 percent of the voting power without acquiring additional stock? Stating the question differently, is E deemed to acquire voting stock in exchange for the nonvoting stock he previously owned? In any event, it is likely that a corporate acquisition occurs when D receives the additional shares in exchange for his capital contribution, as D both acquires stock and increases his voting interest to above 50 percent simultaneously. However, what if D made a capital contribution without receiving shares?

As these two examples suggest, there can be a corporate acquisition as a result of minor changes in the ownership of stock. What is the policy reason for treating such changes in ownership as a corporate acquisition? Compare the definition of "ownership change" in section 382(g) of the Code, which requires a greater than 50 percent change over three years.

B. Leverage Test

9. The following examples and comments relate to the leverage test:

> Example 17. P acquires T. P and T's combined debt-to-assets ratio for the year prior to the acquisition is at least .625:1 (.625 is 1/1.6). Does the acquisition meet the leverage test?

No. The debt-to-assets ratio can never experience the more than 60 percent increase required by the leverage test since the ratio cannot exceed 1:1 (assuming equity is not negative).

More generally, acquisitions by, or of, highly leveraged corporations (or affiliated groups) will rarely, if ever, meet the leverage test. Thus, acquiring corporations that are highly leveraged or have highly leveraged affiliates, such as banks or other financial institutions,* and corporate raiders that have done prior leveraged buyouts, are effectively granted a wholesale exemption from the provisions of the Act that depend on the leverage test.

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* However, note that the assets and liabilities of life insurance company affiliates would not be counted because they are excluded from the definition of affiliated group.

On the other hand, the leverage test can be met in a year through a very small increase in debt if a taxpayer has no debt or very little debt outstanding in the preceding year. Indeed, if a taxpayer had no debt outstanding in the preceding year, the incurrence of any amount of debt would result in an infinite increase in the taxpayer's debt-to-equity and debt-to-assets ratios.

The leverage test has the effect of preferring large companies over small ones as bidders in a corporate acquisition. Consider the following example.

> Example 18. P acquires the stock of T for 50, financing the entire cost with debt. T has no debt and assets with a book value of 50. In the preceding year, P had a debt-to-assets ratio of .5:1 and a debt to equity ratio of 1:1. The assets of P (other than the T stock) are at all times either 50 or 300. Is the leverage test met?

If the assets of P (other than the stock of T) were at all times 50, then the combined debt-to-assets ratio of P and T would increase by 200 percent from .25:1 (25/100) in the preceding year to .75:1 (75/100) in the year of the acquisition, and its debt-to-equity ratio would increase by 8 times from .33:1 (25/75) to 3:1 (75/25), so that the leverage test would be met. On the other hand, if the P assets (other than stock of T) were at all times 300, the combined debt-to-assets ratio would increase by 33 percent from .43:1 (150/350) to .57:1 (200/350) and its debt-to-equity ratio would increase by 77 percent from .75:1 (150/200) to 1.33:1 (200/150), and the leverage test would not be met.

Note that the leverage test is not aimed at increases in debt for which interest deductions are allowed in New York State. The test can be met if the amount of such "New York debt" remains constant and other debt of the taxpayer or its affiliates increases. Thus, the test does not depend on whether the New York State tax base is being eroded through the conversion of equity to debt.

10. Timing is important in applying the leverage test:

> Example 19. T engages in a leveraged recapitalization in one year, and is acquired in January of the following year. Is the leverage test met?

The combined debt-to-equity ratio of P and T for the year may not increase by more than 100 percent over the same ratio for the prior year because of the incurrence of debt by T in the prior year. However, if the debt was incurred late in the year, it may not count that significantly in a yearly average. It apparently makes no difference in applying the test whether the transactions in the two years are related. Conversely, the leverage test may be met if a target engages in a leveraged recapitalization and is acquired in the same year, even though there is no causal connection between the two transactions, or indeed even if the recapitalization is undertaken as a defensive move to prevent subsequent acquisitions.

Example 20. P acquires T at year end incurring $100 million of debt which results in monthly interest of $1 million. T has no debt. Is the leverage test met?

Provided P has not accrued or paid $1 million in aggregate interest in the year of the acquisition, the transaction does not meet the aggregate interest expense test, and thus the transaction does not meet the leverage test. Moreover, even if the aggregate interest expense exceeded the $1 million threshold, a year-end transaction may not satisfy the ratio tests if the "averages" of aggregate debt, equity and assets used in computing the ratios are time-weighted averages.

11. Example 21. The fair market value of T's assets substantially exceeds their recorded book value. If the stock of T were purchased by P, the T assets would be written up to reflect their purchase price under the general rules of "purchase" accounting. What is the effect on the leverage test?.

Because assets are measured based on book value, apparently debt incurred to finance the acquisition would increase the combined debt-to-assets ratio of P and T only to the extent that it exceeds the amount of the write-up in book value multiplied by the combined pre-acquisition ratio. On the other hand, since P's assets are taken into account at book value rather than fair market value, a transaction may meet the leverage test (and thus be subject to the LBO Rules) even though the increase in debt involved is relatively small in relation to the fair market value of P's assets. Book value adjustments may differ, depending on whether P acquires T or T acquires P, producing different results under the statute.

12. Curiously, in applying the definition of subdivision seventeen corporate acquisition (which is generally any corporate acquisition that also meets the leverage test), the debt, equity and assets of target affiliates are counted only when they are part of the acquired person's affiliated group. Therefore, the effect of the target group's high leverage on the leverage test turns on whether it is the target itself or its affiliates that are leveraged. Consider the following example:

> Example 22. P purchases all of the stock of T and finances the purchase with debt. T owns the stock of S, which is highly leveraged. Is there a subdivision seventeen corporate acquisition? What if the purchase of T was not to any degree debt financed?

In applying the definition of subdivision seventeen corporate acquisition, average debt, equity and assets are computed as the sum of the average debt, equity or assets of the acquiring person and the average debt, equity or assets of the target corporation (unless the target is a member of an affiliated group which includes the acquiring person). Where the acquiring person is a member of an affiliated group, all members of the group are treated in the aggregate as the acquiring person. In the example above, T (but not S) is the target corporation. Thus, the debt and assets of S are counted only once S becomes a member of P's affiliated group. Thus, the existence of debt in S will not prevent the occurrence of a subdivision seventeen corporate acquisition, although debt in T could. Conversely, a subdivision seventeen corporate acquisition could occur where P does not incur any debt to buy T because

S's debt would be counted in the acquisition year but not in the prior year.*

13. Where the combined equity of P and T is negative on a book basis, it is not clear how the debt-to-equity ratio test is applied. Consider the following example:

> Example 23. The combined equity of P and T for the year prior to the acquisition is ($10) and their combined assets and liabilities are $10 and $20, respectively. If, in the following year, no changes occur other than that the combined group earns and retains an additional $5 in income, does the debt-to-equity ratio remain constant (at infinity) on the ground that for this purpose equity cannot be less than zero, or is the ratio increased from 2 to 4 or decreased from minus 2 to minus 4? If the answer is that the ratio is considered to decrease from minus 2 to minus 4, then any increase in debt without a corresponding increase in assets would further decrease the debt-to-equity ratio, and a similar decrease in debt would increase the ratio.

This example assumes that equity is measured as the difference between book assets and liabilities. This approach seems consistent with the measurement of assets based on book values. Because equity and liabilities could be measured on a fair market value (rather than book) basis, if a book standard was intended, the point should be more clearly made. Negative equity can arise in a leveraged transaction when purchase accounting is not fully applied.

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* In applying the leverage test in other contexts (e.g., for purposes of the definition of subdivision eighteen corporate merger or consolidation), the ratios are calculated for the preceding taxable year based on the same group of corporations for which the calculation is made for the year in which the merger or consolidation occurs.

14. In calculating the combined debt-to-assets and debt-to-equity ratios for the acquiring person and a target corporation, the target's debt, equity and assets are included as a separate item, unless the target is a member of an affiliated group which includes the acquiring person. Presumably, this exclusion of the target is intended to prevent double-counting of target items after an acquisition. These items would already be included in the aggregate accounts of the acquiring person because the acquiring person is defined to include members of its affiliated group. The Act is silent as to what happens where a target corporation is acquired in the middle of a year. Are the assets, debt and equity of the target ignored in the year's "averages" for the portion of the year in which it is not a member of the acquiror's affiliated group? If so, the target exclusion rule might cause a mid-year acquisition of a corporation with a significant amount of debt not to meet the leverage test.

C. Disallowance of Interest Expense.

15. The following examples and comments concern problems with the operation of the interest expense disallowance rule.

Perhaps the most significant criticism of the rule is that it disallows interest expense on debt that has no causal connection with the acquisition. For example, if P acquired T by issuing P stock to the T stockholders, and in the year of the acquisition P borrowed to buy a plant, 5 percent of the interest expense on the borrowing could be disallowed.

16. The disallowance rule applies, under subclause four of new section 208.9(b)(6-1)(A) of the Tax Law, to each taxpayer that during the taxable year or the three immediately preceding years is a member of an affiliated group that includes a corporation described in subclause one, two or three (generally, an acquiror in a corporate acquisition or an acquisition of assets, or a surviving corporation in a corporate merger or consolidation, if the value of the transaction exceeds $5 million). This rule raises a number of questions.

First, the rule apparently applies without regard to whether the parties to the acquisition are New York taxpayers.* Thus, if a Florida corporation doing business solely in Florida acquires an Indiana corporation doing business solely in Indiana, the interest expense of the affiliates of the Florida corporation that do business in New York arguably is subject to limitation under the Act. Was this intended?

Second, the rule which generally applies to limit the disallowed amount of interest expense in connection with a corporate acquisition refers to the "taxpayer's total cost of any target corporation" (emphasis added).

How does the statute apply to a corporation that is affiliated with an acquiring person but does not itself have any "target cost"? Does the Act apply the "target cost" ceiling separately to each affiliated member's disallowed interest

* The corporations described in subclauses one, two and three do not appear to be limited to corporations that are themselves taxpayers.

expense? Is the target cost allocated among members in some fashion? Or does the Act disallow interest expense only of the actual acquiring corporation and thus apply the limitation only to it? Similar questions arise in applying the limitation to asset acquisitions and mergers or consolidations.

Finally, it is not clear when a taxpayer must be a member of the same affiliated group as the corporation described in subclause one, two or three in order for the disallowance rule to apply. If a taxpayer becomes a member of such group after the acquisition, does the rule apply? Such a result would seem unfair, since it would capture debt that has no possible relationship to an acquisition.

If the New York taxpayer were to terminate its affiliation with the group that includes the acquiror or the surviving corporation in a merger, would it cease to be subject to the disallowance rule? What happens if the acquiring or surviving corporation goes out of existence (for example by being merged with another affiliate)?

17. How is the “cost of target” measured when the consideration includes a contingent payment?

18. The Act's use of the “cost of target” concept raises other questions not answered on the face of the statute. For example, what is the cost of the target where the acquisition

occurs through a redemption of stock by the target? Arguably, a continuing shareholder whose proportionate interest in the target is increased by the redemption incurs no cost. Similar questions arise where a corporate acquisition occurs by way of gift, distribution or otherwise in a transaction where there is in fact no cost to the acquiror.

19. Consider the following example which also concerns the measurement of the target cost:

> Example 24. T distributes assets to its shareholders pro rata in a leveraged recapitalization. P subsequently purchases more than 50 percent of the T stock.

Presumably the "cost of T" to P in this example is the cost of P's equity interest purchased. However, what if the recapitalization and acquisition occurred simultaneously? Would P's "cost of T" then include some portion of the T debt incurred to finance the recapitalization?

> 20. Example 25. P has $10 million of debt outstanding at January 1. On July 1, it acquires T (which itself has no debt) for $100 million. The acquisition is 100 percent debt-financed. Assuming all of P's debt bears a 10% interest rate, P's interest expense for the year of acquisition would be $6 million: $1 million on its pre-existing debt plus $5 million on the acquisition debt outstanding for half the year. What amount of interest is disallowed as a deduction?

The answer depends on whether a deduction for interest on the acquisition debt is disallowed on the ground that the debt is attributable to subsidiary capital (P's interest in T). If the deduction is not disallowed on that ground, then the amount disallowed under the LBO Rules should be five percent of the $5 million of interest on the acquisition debt, which would be $250,000. However, the Act would actually disallow $300,000 (5% of the total interest expense). The limitation based on the cost of target (total deductible interest x (cost of target/average debt for the year), or $6 million x ($100 million/ $60 million)) would be ineffective because the acquisition debt is outstanding only part of the year.

If the deduction for interest on the acquisition debt is fully disallowed on the ground that the debt is attributable to subsidiary capital, then no further interest deductions should be disallowed, since the entire cost of T is accounted for by the $100 million of debt. Nonetheless, it appears that deductions for $50,000 of interest (5% of $1 million) on the pre-existing debt would be disallowed. Again, the limitation based on the cost of target would be ineffective because the cost of target in the numerator of the fraction, and the debt in the denominator, is not reduced by the debt attributable to subsidiary capital.

21. An additional problem with the target cost ceiling is that it apparently ignores post-acquisition changes in the financed portion of this cost.

> Example 26. Same facts as Example 25, except that immediately after being acquired, T sells $75 million of its assets and distributes the proceeds to P which retires a proportionate amount of the acquisition related debt. To the extent the retirement reduces P's debt, the aggregate interest expense and the aggregate debt used in the ceiling formula would be reduced. However, since the numerator remains fixed at the original cost of T, interest may be disallowed on a higher proportion of the debt that is not related to the acquisition.

22. The interest expense disallowance rule may be triggered by an event that is not a corporate acquisition, merger or consolidation, namely the acquisition of more than 80 percent of the assets of a corporation with a value in excess of $5 million (see new section 208.9(b)(6-a)(2) of the Tax Law). Curiously, there is no exception to the asset acquisition definition for transfers that do not involve a change in beneficial ownership, which prompts the following example:

> Example 27. P liquidates its wholly-owned subsidiary S, receiving all of its assets which have a value exceeding $5 million. Apparently, the liquidation may cause the interest expense disallowance rule to become operative.

Note that a merger or consolidation between affiliates which would otherwise be excluded from the Act may be considered an asset acquisition under this rule.

D. Target Affiliates.

23. The rules relating to the disallowance of carryovers and subsidiary capital do not extend to target affiliates. Consider these examples:

> Example 28. TS has various tax attributes which would be lost if it were to be acquired in a transaction covered by the Act. TS is wholly owned by T. P acquires T. What is the effect of the acquisition on TS?

TS's tax attributes are preserved since the Act reaches only the attributes of the directly acquired corporation.

> Example 29. Same facts as Example 28, except that following the acquisition, TS sells substantially all of its assets. Do these sales affect the status of the stock of T in the hands of P as subsidiary capital?

No. T, the directly acquired corporation, has not disposed of its assets and thus P's stock in T would not be treated as investment capital.

Note that sections 382 and 383 of the Code look through intermediate corporations in determining whether an ownership change resulting in a limitation on carryovers has occurred.

E. Subsidiary Capital Provisions.

24. Although the assumption of the rules recharacterizing subsidiary capital as investment capital is that it is always preferable (from a taxpayer's perspective) for an asset to be subsidiary capital rather than investment capital,

that is not always the case. Under section 208.9(b)(6), interest directly or indirectly attributable to subsidiary capital is not deductible in computing entire net income. Thus, the recharacterization of target stock as investment capital may permit a taxpayer to deduct interest on debt attributable to the target stock that would not be deductible if such stock were subsidiary capital. Indeed, the overall effect of the LBO Rules (combining the subsidiary capital rule with the interest disallowance rule) may be to increase the deductible portion of the interest cost on debt incurred to purchase a target corporation from 0 to 95%.

25. New section 208.4(b) of the Tax Law refers to a drop in ownership from more than 50 percent to 50 percent or less of “the number of shares of stock entitling the holder thereof to vote for the election of directors”. Voting shares is not the same as voting power, which is used in the definition of corporate acquisition. The rules should be conformed.

26. Section 208.4(c) applies where a target corporation “sells or otherwise disposes of an asset or assets . . . held by the target corporation on the acquisition date such that immediately prior to such disposition such target corporation owns more than fifty percent of the total of such assets held by the target corporation on the acquisition date . . . and immediately thereafter owns 50 percent or less”. This provision does not have any exception for transfers that do not involve a change in beneficial ownership. Thus it would appear to apply if P purchased the stock of T and within 18 months T incorporated a division holding more than half of its pre-acquisition assets.

F. ITC.

27. If a corporate acquisition, merger or consolidation occurs in a taxable year, the target corporation may not carry over credits to any part of the year. Why shouldn't it be possible to use credits to offset the tax attributable to the pre-acquisition portion of the year?

G. NOLs.

28. If a corporate acquisition, merger or consolidation occurs during a taxable year, the target corporation may not use NOL carryovers for prior years in the acquisition year, or carry over losses for the year to any subsequent year. Why shouldn't it be possible to use prior year NOLs to offset income for the pre-acquisition portion of the year, and to carry over losses attributable to the post-acquisition portion of the year to subsequent years?

H. Application to Individuals.

29. Where a target corporation is acquired by a partnership or S corporation, the leverage test is generally applied at the taxpayer (partner or individual shareholder) level rather than at the acquiring person level. Thus, for example, the test is not met unless a particular partner or shareholder's share of the acquiring person's interest expense exceeds $1 million. This approach gives such pass-through entitles a competitive advantage over C corporations as acquirors. Further, it is not clear how the ratio tests will be applied at the

shareholder/partner level. For example, it would seem that a shareholder of an acquiring person that is an S corporation would not include his share of the debt of the corporation in calculating his debt because he would not be liable for the corporation's debt. Also, individuals do not typically have financial statements that can readily be used in calculating the ratios.