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TAX TREATMENT OF CERTAIN STATUTORY MERGERS

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Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 19562]

The Committee on Finance, to which was referred the bill (H.R. 19562) to amend the Internal Revenue Code of 1954 in relation to corporate reorganizations, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. SUMMARY

This bill amends the tax law to permit a tax-free statutory merger when stock of a parent corporation is used in a merger between a controlled subsidiary of the parent and another corporation, and the other corporation survives—here called a "reverse merger."

The Treasury Department has indicated that it has no objection to the enactment of this bill.

II. REASONS FOR THE BILL

In 1968 Congress added a provision to the tax laws permitting statutory mergers where the stock of the parent of the corporation making the acquisition was used in the acquisition (sec. 368(a)(2)(D)). At the time that statute was enacted, the use of stock of a parent corporation was permitted in the type of reorganization involving the acquisition of stock (subparagraph (B)) and in the type of reorganization involving the acquisition of assets (subparagraph (C)) but was not permitted in the case of a statutory merger of a subsidiary. After noting this fact, the House committee report went on to explain the reasons for the amendment as follows:

> Apparently the use of a parent's stock in statutory mergers was not initially provided for because there was no special concern with the problem at the time of the adoption of the 1954 code. However, this is no longer true. A case has been

called to the attention of your committee in which it is desired to have an operating company merged into an operating subsidiary in exchange for the stock of the parent holding company. Your committee sees no reason why tax-free treatment should be denied in cases of this type where for any reason the parent cannot or, for business or legal reasons, does not want to acquire the assets (even temporarily) through a merger.

For the reasons set forth above your committee concluded that it was desirable to permit the use of the stock of the parent corporation in a statutory merger in acquiring a corporation in essentially the same manner as presently is available in the case of other tax-free acquisitions. (House report on H.R. 18942 (90th Cong.).)

Thus, under existing law, corporation X (an unrelated corporation) may be merged into corporation S (a subsidiary) in exchange for the stock in corporation P (the parent of S) in a tax-free statutory merger. However, if for business and legal reasons (wholly unrelated to Federal income taxation) it is considered more desirable to merge S into X (rather than merging X into S), so that X is the surviving corporation—a "reverse merger"—the transaction is not a tax-free statutory merger.

Although the reverse merger does not qualify as a tax-free statutory merger, it may, in appropriate circumstances, be treated as tax-free as a stock-for-stock reorganization (subparagraph (B)). However, in order to qualify as a tax-free stock-for-stock reorganization it is necessary that the acquisition be *solely* for voting stock and that no stock be acquired for cash or other consideration. Thus, if a small amount of the stock of X (the unrelated corporation) is acquired for cash before the merger of S into X, there often may be doubt as to whether or not the transaction will meet the statutory requirements of a stock-for-stock reorganization.

The committee agrees with the House, that there is no reason why a merger in one direction (S into X in the above example) should be taxable, when the merger in the other direction (X into S), under identical circumstances, is tax-free. Moreover, it sees no reason why in cases of this type the acquisition needs to be made solely for stock. For these reasons the amendment makes statutory mergers tax-free in the circumstances described above.

III. EXPLANATION OF THE BILL

The bill amends the tax laws to permit a tax-free statutory merger of one corporation into another when stock of the corporation in control (here called the "controlling corporation") of the merged corporation is given in the transaction to the shareholders of the survivor corporation in exchange for their stock. Under the new provision (sec. 368(a)(2)(E)) such a statutory merger may be a tax-free reorganization if it meets several conditions.

First, the corporation surviving the merger must hold substantially all of its own properties and substantially all of the properties of the merged corporation (except stock of the controlling corporation distributed in the transaction).

Second, in the transaction, former shareholders of the surviving corporation must receive voting stock of the controlling corporation in exchange for an amount of stock representing control in the surviving corporation. Control for this purpose (defined in sec. 368(c)) means that the amount of stock in the surviving corporation surrendered for voting stock of the controlling corporation must represent stock possessing at least 80 percent of the total combined voting power (in the surviving corporation), and also stock amounting to at least 80 percent of the total number of shares of all other classes of stock (in the surviving corporation). If voting stock of the controlling corporation is used in the exchange to the extent described, additional stock in the surviving corporation may be acquired for cash or other property (whether or not from the shareholders who received voting stock). Of course, this additional stock in the surviving corporation need not be acquired by the controlling corporation.

The amendment applies not only when the only assets of the merged corporation are the nominal capital required to organize it and the stock of its parent which is to be used in the merger exchange but also when the corporation has substantial properties.

In discussions on this bill, the Treasury Department has expressed concern that the corporate reorganization provisions need review and modification. The committee in agreeing to this amendment does not intend to foreclose consideration of any substantive changes which the Treasury may propose in the corporate reorganization provisions in any future presentations.

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

SECTION 368 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of

the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

(2) SPECIAL RULES RELATING TO PARAGRAPH (1).—

(A) REORGANIZATIONS DESCRIBED IN BOTH PARAGRAPH (1) (C) AND PARAGRAPH (1) (D).—If a transaction is described in both paragraph (1) (C) and paragraph (1) (D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1) (D).

(B) ADDITIONAL CONSIDERATION IN CERTAIN PARAGRAPH (1) (C) CASES.—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) TRANSFERS OF ASSETS OR STOCK TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1) (A), (1) (B), AND (1) (C) CASES.—A transaction otherwise qualifying under paragraph (1) (A), (1) (B), or (1) (C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

(D) STATUTORY MERGER USING STOCK OF CONTROLLING CORPORATION.—The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subpara-

graph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation shall not disqualify a transaction under paragraph (1)(A) if (i) such transaction would have qualified under paragraph (1)(A), if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction.

(E) STATUTORY MERGER USING VOTING STOCK OF CORPORATION CONTROLLING MERGED CORPORATION.—A transaction otherwise qualifying under paragraph (1)(A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if—

(i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and

(ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

(b) PARTY TO A REORGANIZATION.—For purposes of this part, the term "a party to a reorganization" includes—

(1) a corporation resulting from a reorganization, and

(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B) or (1)(C) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred. In the case of a reorganization qualifying under paragraph (1)(A) of subsection (a) by reason of paragraph (2)(D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D). *In the case of a reorganization qualifying under subsection (a)(1)(A) by reason of subsection (a)(2)(E), the term "party to a reorganization" includes the controlling corporation referred to in subsection (a)(2)(E).*

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