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RATIONALIZING THE TAXATION OF REORGANIZATIONS AND OTHER CORPORATE ACQUISITIONS

Herwig J. Schlunk

This article examines the taxation of human shareholders in the case of mergers and acquisitions. Currently, the relevant law is extraordinarily complex, utterly inconsistent, and in many instances arguably unfair. There are really only two plausible ways to cure these ills. The first would involve moving to a tax system with more fulsome gain recognition, most likely in the form of mark-to-market taxation. This option is not in my opinion feasible (either technically or what is perhaps more important, politically). Accordingly, the second potential cure, moving to a tax system with less gain recognition, merits attention.

In this article, I propose such a tax system. In particular, under my proposal, a human shareholder whose stock is sold or exchanged pursuant to a merger or acquisition would be entitled to nonrecognition treatment so long as either (1) he receives stock in the acquiring corporation or (2) he involuntarily receives consideration other than stock in the acquiring corporation but promptly and appropriately reinvests such consideration.

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* Professor, Vanderbilt University Law School. I would like to thank my colleagues, Beverly Moran and Jeffrey Schoenblum, for helpful comments.
I. INTRODUCTION

The law governing the tax treatment of shareholders involved in corporate mergers and acquisitions has been relatively stable for the better part of the federal income tax's history. This is remarkable if for no other reason than that Congress generally tinkers with the Internal Revenue Code (Code) at least once a year, and enacts significant tax changes every two or three years. But it is doubly remarkable given the quirky, excessively complex, and utterly inconsistent nature of the applicable "corporate reorganization" rules. Could quirkiness, excessive complexity, and utter inconsistency possibly be a virtue?

What are the benefits of quirkiness, excessive complexity, and utter inconsistency (other than providing employment for tax professionals)? The answer is that these features, taken together, make it possible for shareholders, as a group, to choose how they will
be taxed when they “sell” their corporation. Thus, if shareholders, as a
group, are not averse to recognition, they can choose a taxable
transaction structure. But if enough shareholders are averse to
recognition, they can choose a largely economically equivalent
transaction structure that has the signal difference that it has been
statutorily blessed with nonrecognition treatment. It is surely the
desirability (from the shareholder viewpoint) of this barely hidden
“electivity” that underlies the historic stability of the corporate
reorganization rules. But alas, this electivity is now under attack, at
least in the public company context.

Electivity still operates in the context of mergers and acquisitions
of closely held corporations. In that context, shareholders tend to
have a large degree of common interest. Thus, even if certain
shareholders do not have a loathing of recognition, perhaps because
they desire nothing other than a complete cashing-out to fund a trip
around the world, they tend to appreciate that a like lack of loathing
may not be prevalent among their fellow shareholders (who are not
infrequently beneficiaries of their largesse). Thus, the “selling”
shareholders generally will be willing to accommodate transaction
structures that allow their fellows desiring nonrecognition to achieve
it. Obviously, the corporate reorganization rules aid and abet the
successful search for such structures.

Electivity is no longer the rule in the public company context. In
that context, shareholders tend to have much less common interest.
Increasingly, a large majority of public company shareholders are
indifferent to gain recognition. These include tax exempt
organizations and foreigners, neither of which generally pays any tax
on capital gains. These also include many mutual funds and hedge
funds. Such funds do not themselves pay any tax on capital gains, and
while they must “distribute” all such gains to shareholders who may
pay tax on them, the possibility of somewhat remote taxation tends
not to be too troubling to many fund managers. Finally, these also
include dealers in securities, who must pay tax on gains whether such
gains are technically recognized or not. These various tax indifferent
shareholders tend to prefer receiving cash consideration when they
“sell” their shares in a public company, primarily because cash
consideration has an unvarying value. Unfortunately, unlike “selling”

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2 That electivity is the silent motivation behind the corporate reorganization
rules is illustrated by the only recent “significant” change to those rules, a
liberalization of the continuity of interest regulations in the late 1990s. See Treas. Reg.
§ 1.368-1(e) (2007). The new rules make it significantly easier for taxpayers who do
not care about recognition to accommodate those who do.
shareholders in the closely held corporations' context, tax indifferent shareholders in the public company context are generally unwilling to accommodate the tax planning of their non-tax-indifferent human brethren. Thus, increasingly, human shareholders of public companies are having unwelcome gain recognition events thrust upon them.\(^3\)

This article takes the current increased exposure of human shareholders to unwelcome recognition events as an excuse to reexamine the taxation of corporate mergers and acquisitions in general. It is divided into eight parts. Part II motivates the discussion by detailing two corporate transactions and describing the current wholly irrational and inconsistent taxation of each. It also sets forth the possibilities for taxing such transactions consistently. Part III examines nonrecognition transactions in noncorporate settings, in the hope of finding an economic or perhaps other robust basis for the grant of nonrecognition treatment. Alas, no economic or other robust basis is found. However, several ad hoc noneconomic bases are discussed. Part IV contains an economic analysis of the two corporate transactions detailed in Part II, in order to see how such transactions compare to the nonrecognition transactions described in Part III. It concludes that the corporate transactions are at least as worthy of nonrecognition treatment as the noncorporate transactions.

Part V briefly examines the history of the corporate reorganization provisions of the Code in order to determine whether an earlier Congress believed there was anything unique about the corporate context that justifies either a less or a more liberal nonrecognition regime than is found in non-corporate contexts. The

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\(^3\) We live in an age in which taxable (cash) acquisitions of public companies by management teams, private equity firms, or other corporations are all the rage. In the space of a few recent months, a number of large public companies, including HCA Inc., Freescale Semiconductor, Kinder-Morgan Inc., and Univision Communications Inc., have all announced management-led and private-equity-firm-assisted cash buyouts. These deals are large, worth $20.98 billion, $17.60 billion, $14.56 billion, and $12.23 billion, respectively. See Sarah McBride & Dennis K. Berman, \textit{Clear Channel Buyout Talks Fuel Concern of Management Conflicts}, \textit{Wall St. J.}, Nov. 14, 2006, at A1. Clear Channel Communications itself joined the list the following day, when it agreed to an $18.7 billion buyout. Note that the article failed to mention at least two other roughly contemporaneous deals of comparable size (Harrah's Entertainment, Inc. at $15.4 billion and Albertson's at $11 billion), and of course did not mention any subsequent deals, including the $19 billion deal for Equity Office Properties Trust announced less than a week later (on November 20, 2006). A more recent list of large private equity purchases, both of public companies and of subsidiaries of such companies, can be found in Michael Merced & Eric Dash, \textit{Banks to Test Debt Market this Week}, \textit{N.Y. Times}, Sept. 4, 2007, at C1, C11.
short answer is that no enlightenment is to be found in such history. Part VI begins to tackle the question of rationalizing the tax treatment of corporate mergers and acquisitions. It does this by describing three proposals: one from the early 1980s by the American Law Institute (ALI), one from the late 1980s by David Shakow, and one from the very recent past by Yariv Brauner. Part VII is the heart of the enterprise. It sets forth a menu of consistent tax alternatives and debates the pros and cons of each. It ultimately (and to an academic reader perhaps surprisingly) extols the virtues of a tax regime of expanded nonrecognition treatment. In particular, I propose a tax regime in which shareholders would receive nonrecognition treatment in the context of a merger or acquisition whenever they either (1) exchange their stock for the stock of some other corporate party to the merger or acquisition, or (2) involuntarily exchange their stock for consideration other than stock but promptly and appropriately reinvest such consideration. Part VIII is a brief conclusion.

II. A TALE OF TWO CORPORATE ACQUISITIONS

I will begin my discussion with two corporate acquisitions, each quite different from the other. I make no claim that either of these acquisitions is in any way typical of the larger run of corporate acquisitions. Each is in fact quite unusual. Nonetheless, each is possible, and the tax law must therefore be able to deal with both. How the tax law currently deals with them, and how it should ideally deal with them, is the subject of this article.

A. Acquisition #1, Variant A

Suppose an individual (H) owns all of the stock of a corporation (X) with a tax basis of essentially $0. X is in the oil exploration business; it borrows money, purchases real estate with promising geological markers, and drills for oil. It currently has borrowings of $2 million. Happily, it has just successfully drilled its first well. The well is not a very big one. Still, with a parcel of land and a successful well, X’s assets have an estimated fair value of $3 million. Perhaps more importantly, X’s parcel of land is situated on property that General Electric Corporation (GE) believes would be an ideal location for a new factory. Thus, GE approaches H about the possibility of acquiring X.

Following some back and forth, H agrees to sell X to GE in exchange for $1 million worth of GE’s publicly traded common stock. Accordingly, GE organizes a transitory subsidiary ($) and transfers $1
million of newly issued GE common stock to S in exchange for all of S's stock. Immediately thereafter, S merges with and into X, with X surviving. Pursuant to the terms of the merger agreement, H's X stock is exchanged for the GE common stock owned by S and GE's S stock is converted into all of the outstanding stock of X. Thus, H walks away with a block of GE common stock and X becomes a wholly owned subsidiary of GE.

Given that GE's equity has a market value of nearly $400 billion, H's block of stock represents approximately 0.00025% of GE's outstanding equity. Given that GE's liabilities total nearly an additional $600 billion, so that its assets total nearly $1 trillion, X's assets represent approximately 0.0003% of GE's assets. It follows that for every dollar worth of GE stock H owns, only 0.0003 cents of such dollar reflects a continuing indirect interest in the assets of X. Nonetheless, providing that certain nominal conditions are satisfied,\(^4\) H is not taxed upon his exchange of X stock for GE stock, since such exchange qualifies as a corporate reorganization within the meaning of section 368.\(^5\) Note that this tax result is not adversely impacted by any of the following facts:

The consideration H receives is extremely liquid, since GE stock is actively traded on the New York Stock Exchange.

The consideration H receives is easy to value, since GE stock is actively traded on the New York Stock Exchange.

The consideration H receives represents only a de minimis continuing investment in the assets of X; of the assets underlying any given dollar of H's GE stock, only 0.0003 cents are H's original indirectly owned assets.

The consideration H receives is received as a result of a transaction that H entered into willingly.

**B. Acquisition #1, Variant B**

The facts are the same as for Acquisition #1A, but the mechanics are different. GE finances the acquisition of X by selling $1 million of

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\(^4\) In an excess of caution, in order to avoid any possible argument that the reorganization lacks continuity of business enterprise, GE could consider retaining not just the parcel of land, but the oil well too. Treas. Reg. § 1.368-1(d) (2007). Such retention would not necessarily obligate it to enter a new line of business; it could outsource the actual extraction to some third party contractor.

newly issued shares in the public equity market. It uses the $1 million of cash proceeds to purchase all of $X$’s stock from $H$. $H$ immediately uses the $1 million of cash he receives from $GE$ to purchase $1 million of $GE$ common stock in the public equity market. Thus, the net effect of the sequence of transactions in Variant B is identical, from the vantage of every single party to the acquisition, including $H$, to the transaction in Acquisition #1A. However, the tax consequences under current law are different from those of Acquisition #1A. In particular, since $H$ received cash in exchange for his $X$ stock, he is fully taxed on his gain with respect to such stock, irrespective of how quickly he reinvested such cash in $GE$’s common stock.6

C. Acquisition #2, Variant A

Suppose that an individual ($H$) is a shareholder of a closely held corporation ($X$) who has a tax basis of essentially $0$ in his stock. $X$’s capitalization consists solely of 500,000 shares of Class A Common Stock and 500,000 shares of Class B Common Stock; it has no debt or liabilities of any kind. The Class A shares have a liquidation preference of $40$ per share; after satisfaction of such liquidation preference the Class A shares participate equally with the Class B shares in the receipt of any additional liquidation proceeds. Finally, the Class A shares are entitled to five votes per share, and the Class B shares are entitled to one vote per share. Suppose that $H$ owns 100,000 of the Class B shares. Thus, in rough terms, $H$ owns 10% of the upside appreciation of $X$. However, $H$’s shares entitle him to only 3.33% of $X$’s vote.

$X$ is in the oil exploration business. It owns several parcels of land and has several active wells. Given the wells and related assets, an appraiser has estimated the fair value of $X$’s assets at approximately $30$ million. If the appraisal is accurate, then taking the aggregate $20$ million liquidation preference of the Class A stock into account, $H$’s stock in $X$ should be worth approximately $1$ million. But given the uncertainty inherent in any appraisal, as well as the absence of a liquid market in either $X$’s assets or its stock, who really knows!

$X$ has come to the attention of Roll-Up Co. ($RUC$), a small portfolio company controlled by a private equity fund. $RUC$’s capitalization consists solely of 1 million shares of common stock and $40$ million of long-term debt. An appraiser has estimated the fair value of $RUC$’s assets at approximately $50$ million. If the appraisal is

accurate, then taking the $40 million of debt into account, RUC's stock should be worth approximately $10 million in the aggregate. But once again, who really knows!

RUC and the principals of X enter into negotiations regarding a business combination. After a fair bit of back and forth, centered largely on questions of valuation, they reach an agreement, subject to the approval of X's shareholders, pursuant to which RUC will acquire X. Under the terms of the agreement, X will become a wholly owned subsidiary of RUC; the Class A shareholders of X will receive $40 of cash (funded by $20 million of new borrowing by RUC from a bank (Bank)) and one newly issued share of RUC in exchange for each Class A share of X; the Class B shareholders of X will receive one newly issued share of RUC in exchange for each Class B share of X.

X's shareholders vote on the proposed acquisition. H would like to continue deferring tax on his unrealized gain and accordingly votes "No." However, a large number of X's other shareholders are largely indifferent to tax recognition. Some of these may be tax-exempt organizations that are exempt from capital gains taxation. Others may be mutual funds that do not pay any tax themselves, although some of their shareholders might. And still others may be individuals who have a high tax basis in their shares, either as the result of having recently purchased such shares, or as a result of having been the beneficiaries of the stepped-up basis at death. All of these tax indifferent shareholders vote "Yes."

Accordingly, the acquisition proceeds apace. First, RUC borrows $20 million from Bank. Then, RUC organizes a transitory subsidiary (S) and transfers $20 million in cash and 1 million newly issued shares of RUC common stock to S in exchange for all of S's stock. Immediately thereafter, S merges with and into X, with X surviving. Pursuant to the merger agreement, each Class A share of X stock is exchanged for $40 of the cash and one share of the RUC common stock owned by S, each Class B share of X stock is exchanged for one share of the RUC common stock owned by S, and RUC's S stock is converted into all of the outstanding stock of X. Thus, in particular, H walks away with 100,000 shares of RUC common stock.

Whether or not the aforementioned appraisals were reasonably accurate, H's block of stock represents 5.0% of RUC's outstanding equity. What that equity represents, however, does depend on the

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7 I.R.C. § 512(b)(5).
8 I.R.C §§ 851–855.
9 I.R.C. §§ 1012, 1014(b)(9).
accuracy of the appraisals. Thus, if the appraisals were reasonably accurate, then $X$'s $30 million of gross assets represent 37.5% of $RUC$'s post-acquisition gross assets. As such, it follows that for every dollar worth of $RUC$ stock $H$ owns, 37.5 cents of such dollar reflects a continuing indirect interest in the assets of $X$. Nonetheless, $H$ is taxed upon his exchange of $X$ stock for $RUC$ stock, since such exchange does not qualify as a corporate reorganization within the meaning of section 368.\footnote{The transaction cannot qualify as a corporate reorganization since the transaction structure has been carefully chosen to fail the continuity of interest requirement. Treas. Reg. § 1.368-1(e) (2007); see John A. Nelson Co. v. Helvering, 296 U.S. 374, 376-77 (1935). Moreover, it is not a section 368(a)(1)(D) reorganization, in spite of the 50% overlap of ownership of $X$ and the post-acquisition $RUC$, because section 368(a)(1)(D) does not apply to transfers of stock. I.R.C. § 368(a)(1)(D). Finally, it is not a section 351 transaction since former shareholders of $X$ do not have section 368(c) control of the post-acquisition $RUC$. I.R.C. § 351.} Note that this tax result is not ameliorated by any of the following facts:

The consideration $H$ receives is illiquid, since $RUC$ stock is not traded and is, in fact, effectively controlled by a private equity fund.

The consideration $H$ receives is difficult to value. Note that there were no contemporaneous cash transactions involving the Class B stock. Moreover, the exchange ratio between the Class B stock and the $RUC$ common stock would have been the same for any other combination of values of $X$'s and $RUC$'s aggregate pre-acquisition equity that valued the former at $20 million more than the latter.

The consideration $H$ receives represents a significant continuing investment in the assets of $X$; of the assets underlying any given dollar of $H$'s $RUC$ stock, 37.5 cents are $H$'s original indirectly owned assets.

The consideration $H$ receives is received over his objections as a result of a transaction that he did everything in his power to avoid.

\subsection*{D. Acquisition #2, Variant B}

The background facts are the same as for Acquisition #2A, but the mechanics are different. In this variant, it is $X$ that acquires $RUC$. First, $X$ borrows $20 million from Bank. Second, $X$ recapitalizes its Class A Common Stock; each share of Class A Common Stock is exchanged for one share of Class B Common Stock and $40 of cash. Third, $RUC$ merges with and into $X$, with $X$ surviving. Pursuant to the merger agreement, all issued and outstanding shares of $RUC$ are converted on a one-for-one basis into shares of $X$'s Class B Common Stock and all issued and outstanding shares of $X$ remain outstanding.
From the vantage of each and every party to the acquisition, including \( H \), the net effect of the sequence of transactions in Variant B is economically identical to the transaction in Acquisition #2A (the only difference is that the name of the surviving corporation is \( RUC \) in the first case and \( X \) in the second). However, the tax consequences under current law are different from those of Acquisition #2A. In particular, since \( H \) did not sell, exchange, or otherwise dispose of any of his shares of \( X \)'s Class B Common Stock, he has not suffered a realization event. Accordingly, he is not taxed as a result of Acquisition #2B.

**E. Consistent Frameworks**

I posit that a rational tax law should be consistent. By this I mean that it should tax the substance of \( H \)'s transactions, rather than their form. Thus, so long as one agrees that the substance of Acquisition #1A is the same as the substance of Acquisition #1B and that the substance of Acquisition #2A is the same as the substance of Acquisition #2B, there are only four possible ways for a rational tax law to handle Acquisitions #1 (however consummated) and #2 (however consummated). This is illustrated in Table 1.

**Table 1. Tax Alternatives**

<table>
<thead>
<tr>
<th></th>
<th>Acquisitions #1A and #1B</th>
<th>Acquisitions #2A and #2B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most Intuitively</td>
<td>Taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td>Appealing Law (?)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Least Intuitively</td>
<td>Not taxable</td>
<td>Taxable</td>
</tr>
<tr>
<td>Appealing Law (?)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expanded Recognition</td>
<td>Taxable</td>
<td>Taxable</td>
</tr>
<tr>
<td>Expanded Nonrecognition</td>
<td>Not taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td>Current Law</td>
<td>Not taxable (A) and</td>
<td>Taxable (A) and not</td>
</tr>
<tr>
<td></td>
<td>taxable (B)</td>
<td>taxable (B)</td>
</tr>
</tbody>
</table>

Current law, as noted, taxes Acquisition #1A differently from Acquisition #1B, and taxes Acquisition #2A differently from Acquisition #2B. Thus, it must either be the case that current law is irrational, or that current law divines some substantive difference between Acquisition #1A and Acquisition #1B, and similarly between Acquisition #2A and Acquisition #2B. The substantive difference in
the first case could only be that the interposition of cash in $H$'s hands in Acquisition #1B temporarily gives $H$ lower (transaction) cost access to alternative investment (and consumption) choices than does his receipt of $GE$ stock in Acquisition #1A. The substantive difference in the second case could only be that the name of the surviving corporation somehow matters.

I do not accept that the name of the surviving corporation can ever matter enough that it should determine the tax outcome; after all, the name of the surviving corporation can always be changed.\footnote{It may be argued that names do matter. After all, corporations sometimes spend significant resources on the question of whether and how to change their names. For example, United Air Lines, wanting to emphasize the fact that it was more than an airline (it had expanded into other travel related businesses such as hotels), unveiled the quickly forgotten name, Allegis, with significant fanfare. And Philip Morris, desiring to enlighten the world that it had become much more than a purveyor of cigarettes, heralded its new name, Altria. And the list could go on and on. Nonetheless, in spite of such expenditures and such hooplah, I am not aware of any study that demonstrates that any public corporation has experienced a statistically significant change in its market value solely as a result of the change of its name.}

Thus, there is no rational reason to tax Acquisition #2A differently from Acquisition #2B. On the other hand, I do accept the notion that the interposition of cash may be a sufficiently substantive difference that the tax law can reasonably give it outcome determinative importance, particularly if, as in Acquisition #1B, such interposition is not wholly formal.\footnote{Even if $H$ were contractually required to use his cash proceeds to buy the stock of $GE$, so long as he was required to buy such shares in the public market, the imposition of cash would not be wholly formal since both $GE$ and the public would appear to be in different positions than they would have been in had $GE$ issued shares to $H$ directly (an appearance that is false, of course, if $GE$ simply reduced its own periodic public market share repurchases by the amount of the cash paid to $H$). Note that the tax result would arguably be different if $H$ were contractually obliged to purchase the shares from $GE$, rather than in the public market. In such case, all cash that initially flowed out of $GE$ would flow right back into $GE$. Accordingly, a substance-over-form analysis would arguably become applicable, and would likely allow the Internal Revenue Service (Service), and possibly even $H$, to ignore the interposition of cash.} Still, given the fleeting nature of the interposition of the cash in such acquisition, this is surely not the best position for a rational tax law to take.

If as just suggested the circumstances support taxing $H$ in a consistent way for his role in each of Acquisition #1 (however consummated) and Acquisition #2 (however consummated), the most intuitively appealing way to tax him is surely to tax him for his part in the former, but not for his part in the latter. (It follows that the least
intuitively appealing way to tax \( H \) is to tax him for his part in the latter, but not for his part in the former.) Why? In Acquisition \#1, \( H \) affirmatively chooses to exchange his highly illiquid corporate stock for highly liquid corporate stock that has no meaningful economic connection with his original investment. Such a transaction all but screams for the recognition of gain and the imposition of tax. On the other hand, in Acquisition \#2, \( H \)'s investment is modified without his acquiescence, his highly illiquid corporate stock remains highly illiquid, and the assets underlying such stock in significant measure continue to be the same. Such a transaction may or may not scream for nonrecognition treatment. But if there is any proper place for nonrecognition treatment in the context of corporate reorganizations or other acquisitions, this is surely it.

There are two other ways for a rational tax law to handle \( H \)'s part in Acquisitions \#1 and \#2. The one generally favored by tax academics would call for expanded recognition: \( H \) would be condemned to full and immediate recognition of gain for his part in Acquisition \#1 (however consummated) and Acquisition \#2 (however consummated). The most prevalent argument in support of this treatment is based on the premise that the realization principle, with its attendant deferral of tax on some economic income, damages an income tax system by distorting taxpayer behavior.\footnote{For a discussion specifically limited to the reorganization context, see Yariv Brauner, \textit{A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations}, 2004 BYU L. REV. 1 (2004). For more general discussions, see Alan J. Auerbach, \textit{Retrospective Capital Gains Taxation}, 81 AM. ECON. REV. 167 (1991); David J. Shakow, \textit{Taxation without Realization: A Proposal for Accrual Taxation}, 134 U. PA. L. REV. 1111 (1986); Reed Shuldiner, \textit{A General Approach to the Taxation of Financial Instruments}, 71 TEX. L. REV. 243 (1992). Note, however, that not all scholars decry realization. David M. Schizer has argued that realization can be seen as a (useful) subsidy encouraging private savings and investment. David M. Schizer, \textit{Realization as Subsidy}, 73 N.Y.U. L. REV. 1549 (1998). Edward A. Zelinsky has argued that realization is better than the alternatives, primarily because it is administratively achievable. Edward Zelinsky, \textit{For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues}, 19 CARDOZO L. REV. 861 (1997).}

In particular, taxpayers disproportionately invest in assets that provide potential deferral, and then hold such assets far longer than they would in the absence of deferral (the so-called "lock-in effect").\footnote{See Alan J. Auerbach, \textit{Retrospective Capital Gains Taxation}, 81 AM. ECON. REV. 167 (1991).}

Of course, under current law, attempted corporate reorganizations (such as Acquisitions \#1A and \#2A) do not actually
rely on the realization principle for special tax treatment. Such
reorganizations are conceded to involve realization events; they
merely involve realization events that, if a number of specific
requirements are satisfied (as they are in Acquisition #1A but not in
Acquisition #2A), are statutorily favored with nonrecognition

treatment, i.e., additional deferral above and beyond that generally
provided by the realization principal.\textsuperscript{15} To an academic who is
predisposed to opposing the deferral of tax even in the case of
nonrealization events (such as Acquisition #2B), extending such
deferral to instances of conceded realization is like rubbing salt in a
wound, unless some very good alternative justification for deferral can
be found. Unfortunately, the one such justification which would
probably serve — namely that the corporate reorganization provisions
encourage economically efficient transactions that otherwise would
not occur — is woefully lacking in empirical support.\textsuperscript{16}

The final possibility for a rational income tax regime is to expand
the availability of nonrecognition treatment, and specifically to favor
$H$ with nonrecognition treatment for his part in both Acquisition #1
(however consummated) and Acquisition #2 (however consummated).
So long as the context is a modification of the income tax, this
possibility has not elicited much recent academic support.\textsuperscript{17}
Nonetheless, it did elicit considerable support in an earlier age when
scholars did not so universally revile the deferral of tax.\textsuperscript{18} The primary
motivation for expanding nonrecognition treatment to all
shareholders, like $H$, who (ultimately) receive consideration consisting
solely of stock of the acquiring corporation, was tax simplification.\textsuperscript{19}
But a secondary motivation was the unfairness of making one

\textsuperscript{15} See I.R.C. §§ 354, 361, 1001.
\textsuperscript{16} See Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition
Rules Under the Federal Income Tax, 48 TAX L. REV. 1 (1992); see also Brauner, supra
note 13.
\textsuperscript{17} Many academics advocate replacing the income tax with a consumption tax or
a cash-flow tax. David F. Bradford, What are Consumption Taxes and Who Pays
Them?, 39 TAX NOTES 383 (Apr. 18, 1988). If such a change were to be made,
realization and \textit{a fortiori} recognition would cease to play a role in determining the tax
base. Thus, Acquisition #2 would indeed be taxed in the same way as Acquisition #1.
However, achieving such equalization would be only a by-product of, not an explicit
motivation for, adopting a consumption tax or a cash-flow tax.
\textsuperscript{18} See AM. LAW INST., FEDERAL INCOME TAX PROJECT SUBCHAPTER C 167
(1982) [hereinafter ALI PROJECT]. Note that the American Law Institute (ALI)
Project would not actually have provided $H$ with nonrecognition treatment in the case
of Acquisition #1B; the interposition of cash, however transitorily, would be fatal.
\textsuperscript{19} Id. at 155.
shareholder's tax treatment depend on the tax treatment of his fellow shareholders (as is the case with H's tax treatment in Acquisition #2A).

III. NONRECOGNITION TREATMENT IN GENERAL

A. Non-Corporate Contexts

In order to put corporate reorganizations and other acquisitions into an appropriate context, it is useful to compare them with transactions outside of the corporate context that are favored with nonrecognition (and in some cases nonrealization) treatment. But in what ways should these transactions be compared? I think that the only way to meaningfully compare transactions is to measure their impact on the one thing that the investing taxpayer cares most about: his investment return. I propose an admittedly ad hoc arithmetic approach. An individual (H) initially owns a capital asset (X) in which he has a significant unrealized capital gain. If H does nothing, but remains the owner of X, he will experience a certain additional (positive or negative) investment return over some relevant time horizon. If X does something, that is, if X modifies his ownership position in X in some way, he will over the same time horizon experience a possibly very different additional investment return. I ask initially: "Is favorable tax treatment in any way limited to circumstances where the post-modification additional investment returns do not differ too materially from the unmodified additional investment returns?"

Consider the following hypothetical investment. H owns asset X which has a tax basis of $2 million and a fair value of $3 million, and which is subject to a liability of $2 million. Over the relevant time horizon, assume that X generates sufficient current cash flow to exactly provide both the lender and H with appropriate risk-adjusted returns, but no more. At the end of the relevant time horizon, X

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20 Id. at 164; see also Bernard Wolfman, "Continuity of Interest" and the American Law Institute Study, 57 TAXES 840, 842 (1979).

21 The concrete numbers behind the model are as follows. The time horizon is three years. All parties are risk-neutral. The interest rate is 10% per annum. Thus, X generates $300,000 of annual cash at the end of the first, second, and third year; immediately after distribution of the third year's annual cash, X adjusts in value. Assuming that annual cash is distributed in the same ratios in each year, and assuming that X's ultimate change in value is properly priced in the market, it will be the case that H will receive $62,235 of annual cash flow and the lender will receive the remaining $237,765.
generates a single terminal random cash flow that with equal probability lies anywhere between $1 million and $5 million. Thus, 25% of the time, H's unrealized gain of $1 million will evaporate (since X's terminal cash flow of less than or equal to $2 million will be entirely dedicated to repaying the lender). The remaining 75% of the time, H will receive an additional capital-gain-type return that with equal probability lies anywhere between -100% and +200%. H's expected additional “capital gain” is +12.5%.

There are a number of transactions that H, as the owner of X, can engage in that will modify the returns from his investment in X but that will not subject him to immediate taxation on his $1 million of unrealized gain. The first I will consider is an installment sale subject to section 453. While the ability to report gain on the installment method may not appear to be a typical nonrecognition provision —

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22 Installment sales are generally subject to so-called interest charge rules imposed by section 453A, rules that are designed to significantly reduce the benefits of tax deferral. I.R.C. § 453A. However, these rules will not apply in the instant case since the aggregate amount of H's outstanding installment sale notes will be below the $5 million threshold.
after all, the realized gain is reported and taxed — it has the same effect. Gain is reported and taxed only as cash is received. This pattern of taxation is precisely the same as that under the broader run of nonrecognition provisions, such as the reorganization provisions themselves.\(^{23}\) The only difference is that in the case of an installment sale, but not in the case of any of the other nonrecognition provisions, \(H\) generally knows at the time of such sale exactly when and how much cash is likely to be received.\(^{24}\)

The generally parroted rationale for allowing nonrecognition treatment in the case of a gain realized by virtue of an installment sale is that the recipient of an installment sale note has not received a liquid asset, and hence has no cash with which to pay his tax liability.\(^{25}\) While this bleak characterization of the recipient’s posture may be technically true (i.e., among other things, the recipient may have no other liquid assets with which to pay the tax that is imposed on his $1 million realized gain), it should never be forgotten that the recipient’s difficulties are to at least some extent self-inflicted. Indeed, given the modern world’s relatively robust capital markets, I would venture to say that of the two statements — (1) \(H\) paid tax on his gains under the installment method because the buyer of \(X\) insisted on paying for \(X\) with a note, and (2) \(H\) insisted that the buyer of \(X\) pay for \(X\) with a note so that \(H\) would be able to pay tax on his gains under the installment method — the second is far more likely to be true.

In order to compare apples to apples, I assume that \(H\) sells asset \(X\) in exchange for a note that pays an amount of current interest that is equal to the current cash flow \(H\) would have received from \(X\). I also assume that \(H\) receives in addition a principal amount of $3.125 million at the same time that \(X\) generates its terminal cash flow.\(^{26}\) It is pretty obvious, as illustrated in the chart below, that the returns generated by \(H\)’s modified portfolio bear little relation to the returns that \(H\) would have received had he not entered into the installment sale. To quantify the overlap of such returns in an ad hoc sort of way,

\(^{23}\) Others include sections 351 (corporate formations), 721 (contributions of property to partnerships) and 1031 (like-kind exchanges). I.R.C. §§ 351, 721, 1031.

\(^{24}\) This is not true, however, in the case of a contingent payment installment sale. See Treas. Reg. § 15a.453-1(c) (1994).

\(^{25}\) WILLIAM A. KLEIN, JOSEPH BANKMAN & DANIEL N. SHAVIRO, FEDERAL INCOME TAXATION 250 (14th ed. 2006).

\(^{26}\) Thus, the note pays interest of $62,235 per year for three years, and then pays the principal amount at the end of year three. As it does not affect my discussion, I ignore the possibility that \(H\) might need to recharacterize a part of the $1.125 million payment, received at the end of year three, as interest.
note that $H$'s return after entering into the installment sale will be within 10% of what his return would have been had he not entered into such sale only 5% of the time (i.e., for values of $X$ between $3.025$ million and $3.225$ million). Thus, $H$ receives nonrecognition treatment with respect to an investment modification that has very materially impacted his investment returns.

Somewhat less dramatic, but along the same general lines as an installment sale (at least in terms of its effect on $H$'s additional investment returns: increasing such returns during “bad” states of the world and decreasing them during “good” states of the world), are various investment modifications involving options. Thus, for example, $H$ could purchase a put option that gave him the right but not the obligation to sell $X$ at the end of three years for $3$ million, in exchange for a mandatory payment, also to be made at the end of three years, in the amount of $375,000$. The net effect would thus be that $H$ would receive a return of at least $625,000$ (i.e., $3$ million minus $2$ million debt repayment minus $375,000$) on his investment. Or, $H$ could sell a call option that gave the buyer the right but not the obligation to purchase $X$ at the end of three years for $4$ million, in exchange for a mandatory payment, also to be made at the end of three years, in the amount of $125,000$. The net effect would thus be
that \( H \) would be unable to receive a return in excess of $2.125 million on his investment.

Note that \( H \)'s additional investment return after purchasing the given put option will be within 10% of what such return would have been had he not purchased the put option only 5% of the time (i.e., for values of \( X \) between $2.525 million and $2.725 million). Furthermore, his additional investment return after selling the given call option will be within 10% of what such return would have been had he not sold the call option only 5% of the time (i.e., for values of \( X \) between $4.025 million and $4.225 million). As in the case of the installment sale, \( H \) has materially modified his additional investment returns. Nonetheless, he is not taxed on his unrealized gains at the time that he enters into these modifications. Indeed, in these cases, \( H \) continues to enjoy deferral with respect to his unrealized gains in \( X \) not because the Code grants him nonrecognition treatment, but rather because the Code does not even acknowledge that the investment modification is a realization event and, as such, could be taxed. That is, \( H \) legally owned asset \( X \) prior to entering in to the option...
transaction, and he continued to legally own asset X (although not necessarily all of the investment upside or downside of asset X) after entering into the investment modification. Thus, section 1001 has no sale or exchange or other disposition upon which to operate.27

The third investment modification I want to consider is a like-kind exchange that garners nonrecognition treatment by virtue of the application of section 1031. In order for H’s modification to qualify for like-kind exchange treatment, X must be the right sort of asset (e.g., real estate that is either held for investment or used in the conduct of an active trade or business), and X must be exchanged for an asset (Y) that is also the right sort of asset (i.e., is of “like kind” with asset X).28 Since under the tax regulations an exchange of undeveloped farm land in Kansas for an office building in Manhattan qualifies as a like-kind exchange, it should be apparent that, at least in the case of real property, H may engage in a wide variety of exchanges, with vastly different possible economic outcomes, and still obtain the blessings of section 1031.29

Why are such exchanges granted nonrecognition treatment?30 One contributing factor is the liquidity rationale already mentioned in the context of installment sales. That is, if H realizes gain on an exchange of asset X for asset Y, he does not necessarily have any cash with which to pay the tax on his gain. Once again, however, the strength of this rationale is subject to considerable doubt, particularly since the Code goes out of its way to allow H to inflict this wound upon himself. That is, provided that H acts with dispatch, and properly dots his i’s and crosses his t’s, he can engage in a like-kind exchange even though the buyer of X actually pays cash for such asset!31

The second, and perhaps more important factor, is that a classic like-kind exchange produces no pricing information which can be used to measure gain. As a result, if H exchanges asset X for asset Y, all that can be said with certainty is that asset X and asset Y are of equal value (in the sense that two presumably informed and rational economic actors were willing to exchange them in an arms’ length

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27 I.R.C. § 1001. Note that entering into these specific options transactions would not result in a deemed realization by virtue of the constructive sales rules. I.R.C. § 1259.
28 I.R.C. § 1031.
30 See generally Marjorie E. Kornhauser, Section 1031: We Don’t Need Another Hero, 60 S. CAL. L. REV. 397 (1987).
31 I.R.C. § 1031(a)(3).
exchange); as to whether that value is $1 or $1 thousand or $1 million or $1 billion there is no information whatever. Again, the classic case is surely not the typical case. Often very precise valuation data exists. In cases involving three party exchanges under section 1031(a)(3), that very precise data is based on amounts of cash actually paid. Nevertheless, for a subset of cases, the valuation concern may be legitimate.

In any event, in order to compare apples to apples, I assume that $H$ exchanges asset $X$, subject to its liability, for like-kind asset $Y$ with the following characteristics. $Y$ has a fair value of $5 million and is acquired subject to a liability in the amount of $4 million. Over the relevant time horizon, $Y$ generates sufficient current cash flow to exactly provide both the lender and $H$ with appropriate risk-adjusted returns, but no more.\footnote{The concrete numbers behind the model are exactly as they were for $X$. The time horizon is three years. All parties are risk-neutral. The interest rate is 10\% per annum. Thus, $Y$ generates $500,000 of annual cash at the end of the first, second, and third year; immediately after distribution of the third year's annual cash, $Y$ adjusts in value. Assuming that annual cash is distributed in the same ratios in each year, and assuming that $Y$'s ultimate change in value is properly priced in the market, it will be the case that $H$ will receive $62,235 of annual cash flow and the lender will receive the remaining $437,765.} At the end of the relevant time horizon, $Y$ produces a single terminal random cash flow that with equal probability lies anywhere between $0 and $8.33 million. Thus, 48\% of the time, $H$'s initial investment and unrealized gain of $1 million will evaporate (since $Y$'s terminal cash flow of less than or equal to $4 million will be entirely dedicated to repaying the lender). The remaining 52\% of the time, $H$ will receive an additional capital-gain-type return that with equal probability lies anywhere between -100\% and +333\%. $H$'s expected additional “capital gain” is +12.5\%.

Finally, for ease of mathematical exposition, I begin with the simplifying assumption that the terminal values of $X$ and $Y$ are uncorrelated. Under this admittedly extreme assumption, $H$'s additional investment return after engaging in the exchange will be within 10\% of what such return would have been had he not engaged in the exchange only approximately 15.3\% of the time (with nearly 90\% of such overlap arising in situations where one or both of $X$ and $Y$ has a value that is below that of its accompanying liability).
Of course, even if $X$ and $Y$ are very different assets — like undeveloped farm land in Kansas and an office building in Manhattan — the returns from such assets are likely to be somewhat, albeit less than perfectly, correlated by virtue of the fact that certain factors, like interest rates and the general business climate, tend to impact all asset prices in similar ways. Accordingly, and again for ease of mathematical exposition, I will make the opposite simplifying assumption, namely that the terminal values of $X$ and $Y$ are perfectly correlated. Under this also admittedly extreme (but polar opposite) assumption, $H$'s additional investment return after engaging in the exchange will be within 10% of what such return would have been had he not engaged in the exchange only approximately 32.3% of the time (with nearly 85% of such overlap arising in situations where one or both of $X$ and $Y$ has a value that is below that of its accompanying liability).
Given a more realistic assumption of partial but not complete correlation, a result in between those presented above would be produced. Whatever such intermediate result, however, H would receive nonrecognition treatment with respect to an investment modification that has very materially, albeit not as materially as in the installment sale context, impacted his additional investment returns.

Just as a focus on additional investment returns makes the installment sale statute seem more generous than the like-kind exchange statute, so too does a focus on investment characteristics. That is, the like-kind exchange statute can be viewed as providing nonrecognition treatment on narrower grounds — liquidity concerns compounded by valuation concerns, as opposed to liquidity concerns standing alone — than does the installment sale statute. But there are other statutes that provide nonrecognition treatment on arguably broader grounds even than the installment sale statute. Thus, if H’s asset X is “qualified small business” stock, H may defer the recognition of gain from a cash sale of X so long as H expeditiously reinvests his sales proceeds in other qualified small business stock.33

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33 See I.R.C. § 1045(a). Qualified small business stock is defined in section
It is difficult to argue that this provision has anything to do with sound tax policy; it was presumably enacted for the benefit of private equity firms and other such generally legislatively neglected folks. Nonetheless, its specific carrot — deferral of realized gain — is one that begs for justification, since its impact depends entirely on the existence and the magnitude of H’s realized gain. If the underlying theory is neither illiquidity (H sold X for cash) nor the possible imprecision of the measurement of gain (H sold X for cash), what is it? The answer, which will make its appearance again, albeit in an arguably more principled way when I return to the corporate reorganization context, is that H should not be taxed on his gain with respect to X because such gain represents nothing more than “paper profits.” That is, H may yet lose some or all of such gain if his subsequent investment performs sufficiently poorly! So phrased, this theory has no logical limit short of a conversion of the income tax into a consumption or cash-flow tax; that is, the theory applies equally well to any cash sale of any asset so long as the proceeds are reinvested in any alternative asset.

Finally, if H’s asset X is indeed “qualified small business” stock, how are H’s additional investment returns likely to differ as a result of selling such stock and reinvesting the proceeds in other qualified small business stock? The answer to that question lies above; the question is identical to that obtained in the like-kind exchange context.\textsuperscript{34}

\begin{table}
\centering
\begin{tabular}{|l|c|c|}
\hline
Transaction Type & Lack of Liquidity & Hard to Value \\
\hline
Installment Sale & Yes & No \\
\hline
Like-Kind Exchange & Yes & Yes \\
\hline
Qualified Stock Rollover & No & No \\
\hline
\end{tabular}
\end{table}
IV. A TALE OF TWO CORPORATE ACQUISITIONS (CONTINUED)

Before examining the question of whether there is anything special about corporate mergers and acquisitions that justifies treating them either more favorably or more harshly than other transactions that are (assuming the statutory prerequisites are met) granted nonrecognition treatment, it is worthwhile to examine how Acquisitions #1 and #2 compare, purely in terms of additional investment returns, with the transactions discussed immediately above.

A. Acquisition #1

I assume that but for the purchase of X stock by GE, X would have produced investment returns for H that are identical to those described for the like-named asset X in the prior part of this article. That is, H's X stock represents all of the equity of a corporation that has assets valued at $3 million and liabilities of $2 million. I assume that X's assets, over the relevant three-year time horizon, would have generated sufficient current cash flow to exactly provide both the lender and H with a 10% annual return, taking the assets' terminal cash flow into account. At the end of three years, the assets would have generated a single terminal random cash flow that with equal probability would have been anywhere between $1 million and $5 million. Thus, 25% of the time, H's unrealized gain of $1 million would have evaporated (since the assets' terminal cash flow of less than or equal to $2 million would have been entirely dedicated to repaying liabilities). The remaining 75% of the time, H would have received an additional capital-gain-type return with respect to his X stock that, with equal probability, would have been anywhere between -100% and +200%. H's expected additional "capital gain" would have been +12.5%.

How shall I model the investment returns from owning GE's stock? Given both GE's size and the diversity of its businesses, it is unrealistic to even pretend that such returns will look anything like those of the asset Y in the prior part of this article. Thus, I assume that GE's $1 trillion worth of assets will produce a terminal gross return...
that, with equal probability, lies anywhere between $850 billion and $1.25 trillion. Thus, an initial investment of $1 million in GE stock may fall in value to $625,000, or rise in value to $1.625 million, or do anything in between. It follows that H receives an additional capital-gain-type return that, with equal probability, lies anywhere between -37.5% and +62.5%. H’s expected additional “capital gain” is +12.5%.

Finally, for ease of mathematical exposition, I begin with the simplifying assumption that the terminal values of X and GE are uncorrelated. (Since X’s assets are now a part of GE’s overall asset base, this cannot literally be true. However, I can safely ignore the effects of X’s assets on GE’s returns as they will be clearly immaterial.) Under this admittedly extreme assumption, H’s additional investment return after selling his X stock to GE will be within 10% of what such return would have been had he not made such sale only approximately 6% of the time.

Of course, even though X’s assets and GE’s assets are very different, the returns from such assets are likely to be somewhat, albeit less than perfectly, correlated. Accordingly, and again for ease of mathematical exposition, I will make the opposite simplifying
assumption, namely that the terminal values of $X$ and $GE$ are perfectly correlated. Under this also admittedly extreme (but polar opposite) assumption, $H$'s additional investment return after selling his $X$ stock to $GE$ will be within 10% of what such return would have been had he not made such sale only approximately 6.7% of the time.

![Acquisition #1 (Perfectly Correlated)](image)

Given a more realistic assumption of partial but not complete correlation, a result in between those presented above would be produced. Whatever such intermediate result, however, $H$'s additional investment returns realized as a result of the sale of $X$ to $GE$ will differ materially from what such returns would have been had he not sold $X$ to $GE$.

**B. Acquisition #2**

Whereas it would have been highly unrealistic to model $GE$'s investment returns on those of asset $Y$ in the prior part of this article, it is not at all unrealistic to model $RUC$'s returns on the returns of such asset. After all, $RUC$ is relatively small and highly undiversified.
Thus, I assume that prior to its combination with $X$, $RUC$'s assets were like asset $Y$. To wit, such assets had a fair value of $5$ million and were acquired subject to liabilities in the amount of $4$ million. Over the relevant three year time horizon, $RUC$'s assets would have generated sufficient current cash flow to exactly provide both its lenders and its shareholders with a 10% annual return. At the end of three years, $RUC$'s assets would have produced a single terminal random cash flow that, with equal probability, would have been anywhere between $0$ and $8.33$ million. Thus, 48% of the time, $RUC$'s shareholders would have been wiped out (since the assets' terminal cash flow of less than or equal to $4$ million would have been entirely dedicated to repaying $RUC$'s lenders). The remaining 52% of the time, $RUC$'s shareholders would have received a capital-gain-type return that, with equal probability, would have been anywhere between -100% and +333%. The expected “capital gain” would have been +12.5%.

How does $X$'s combination with $RUC$ affect $H$'s investment performance? To measure the change, I must combine the gross returns from $X$'s pre-combination assets and the gross returns from $RUC$'s pre-combination assets. For ease of mathematical exposition, I will perform such combination under the simplifying assumption that the terminal values of $X$'s assets and $RUC$'s assets are uncorrelated. Under this admittedly extreme assumption, $H$'s additional investment return after the combination of $X$ and $RUC$ will be within 10% of what such return would have been had the combination not been consummated only approximately 17.7% of the time (with nearly 80% of such overlap arising in situations where both $X$ and $RUC$ are worthless, since their liabilities exceed the fair value of their assets).
Of course, the returns from X’s and RUC’s assets are actually likely to be rather well correlated, given that the assets are of a very similar type. Accordingly, and again for ease of mathematical exposition, I now make the opposite simplifying assumption, namely that the terminal values of X’s and RUC’s assets are perfectly correlated. Under this also admittedly extreme (but polar opposite) assumption, H’s additional investment return after the combination of X and RUC will be within 10% of what such return would have been had the combination not been consummated approximately 36.8% of the time (with nearly 75% of such overlap arising in situations where both X and RUC are worthless, since their liabilities exceed the fair value of their assets).
Given a more realistic assumption of partial but not complete correlation, a result in between those presented above would be produced. Whatever such intermediate result, however, H’s additional investment returns realized as a result of the combination of X and RUC will differ materially from what such returns would have been but for the combination.

C. Summary

As can be seen from Table 3 below, Acquisitions #1 and #2 are not, in terms of their economic characteristics, beyond the pale of exchanges that routinely garner nonrecognition treatment. Indeed, under this criterion, Acquisition #1 is marginally more deserving of nonrecognition treatment than is an installment sale of the very same asset, and Acquisition #2 is marginally more deserving of nonrecognition treatment than would be a like-kind exchange or a qualified stock rollover of the very same asset (were such a transaction possible).
TABLE 3.

<table>
<thead>
<tr>
<th>Transaction Type</th>
<th>Returns within 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installment Sale</td>
<td>5%</td>
</tr>
<tr>
<td>Acquisition #1</td>
<td>6.0% to 6.7%</td>
</tr>
<tr>
<td>Like-Kind Exchange</td>
<td>15.3% to 32.3%</td>
</tr>
<tr>
<td>Qualified Stock Rollover</td>
<td>15.3% to 32.3%</td>
</tr>
<tr>
<td>Acquisition #2</td>
<td>17.7% to 36.8%</td>
</tr>
</tbody>
</table>

This is hardly a ringing endorsement for granting Acquisitions #1 and #2 nonrecognition treatment. It would arguably be best to simply eliminate such treatment for all of the listed transactions. However, if nonrecognition treatment for the installment sale and the like-kind exchange (and the qualified stock rollover) are not going to be eliminated (and my belief is that it is not going to be eliminated any time soon), then, unless one has no qualms about incrementally discriminating against the more common run of investments made in corporate form in favor primarily of investments made in noncorporate form (and one should have such qualms since the entire apparatus of double taxation already discriminates against investments made in corporate form), some other justification must be found to exclude one or both of Acquisitions #1 and #2 from the nonrecognition club.

Fortunately (or perhaps unfortunately), the traditional justifications for granting nonrecognition treatment to a transaction apply with about as much force to Acquisitions #1 and #2 as they apply to noncorporate nonrecognition transactions. This is illustrated in Table 4 below. Based on those justifications, Acquisition #2 makes a strong case for nonrecognition treatment, very much in line with the case made by a classic like-kind exchange. Further, while Acquisition #1's case for nonrecognition treatment is quite weak, it is no weaker (and in Variant 1A marginally stronger, since H never actually has cash in his hands) than the case made by a qualified stock rollover.

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36 Kornhauser, supra note 30, at 448; Shaviro, supra note 16, at 66.
I am not unmindful of one possibly vocal objection to the premises underlying the foregoing Table 4. Is it not the case that what is and what is not blessed in the Code is largely or even purely a question of political whim? Put differently, is not the political clout of the real estate industry the best explanation for why like-kind exchanges receive nonrecognition treatment, or at least for why it is so much easier to qualify real estate exchanges under section 1031 than it is to qualify exchanges of personal property? And is not the political clout of the investment community, or perhaps Congress’ sincere desire to help spur small business formation, the best explanation for the qualified stock rollover provision?

While I agree that these observations have some (perhaps even considerable) explanatory power in delineating the contours of various nonrecognition provisions, I think they provide little of the philosophical justification for the actual existence of such provisions. Thus, “the principal congressional objective in allowing [the installment] method is to provide relief from the harshness of an obligation to pay taxes when the taxpayer has not received cash with which to pay those taxes.”

Furthermore, the congressional concerns leading to enactment and retention of the like-kind exchange provision were squarely valuation-based: “If all exchanges were made taxable, it would be necessary to [value] the property received in exchange in thousands of horse trades and similar barter transactions each year.”

Since nonrecognition treatment can be justified for certain classes

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37 KLEIN, BANKMAN & SHAHIRO, supra note 25.
of corporate reorganizations and other acquisitions along these same philosophical lines, and as will become clear below, not only along these lines but along other lines as well, it follows that absent some particularly good (political or other) reason to exclude such classes of corporate reorganizations and other acquisitions from nonrecognition treatment, they should be granted such treatment.

V. THE HISTORIC RATIONALES FOR THE NONTAXATION OF CORPORATE REORGANIZATIONS

The corporate reorganization provisions, broadly defined as Part III of Subchapter C of the Code, bestow nonrecognition treatment upon certain parties to certain mergers, acquisitions, and other corporate transactions, and of particular relevance to this article, delineate the extent of nonrecognition treatment to be enjoyed by a human shareholder $H$ who exchanges his $X$ corporation stock for stock, securities, or other consideration as a result of a merger, acquisition, or similar transaction involving $X$. They entered the Code by way of the Revenue Act of 1918.\(^{39}\) Although the legislative history of the original statute is sparse, what there is of it indicates a desire on the part of Congress to provide nonrecognition treatment in circumstances involving "purely paper transactions."\(^{40}\) Unfortunately, it was as unclear in 1918 as it is today what exactly is meant by the phrase "purely paper transaction."\(^{41}\)

Congress immediately\(^{42}\) and frequently\(^{43}\) set to work clarifying the

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\(^{39}\) The definition was initially set forth in section 202(b) of the Revenue Act of 1918. Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060 (1918).


\(^{41}\) See Brauner, supra note 13, at 52–53 (discussing the Supreme Court's wrestling with this basic issue in Eisner v. Macomber, 252 U.S. 189 (1920); United States v. Phellis, 257 U.S. 156 (1921); and Weiss v. Stearn, 265 U.S. 242 (1924)).


\(^{43}\) The Revenue Act of 1924 again altered the reorganization definition and moved it to section 203(h)(1). Revenue Act of 1924, Pub. L. No. 68-175, § 203(h)(1), 43 Stat. 253, 257 (1924). Additional changes were ushered in by the Revenue Acts of 1928, 1932, and 1934, which ultimately relocated the reorganization definition to section 112(g). These and subsequent changes from the early years of the federal income tax can best be tracked in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws: 1938-1861 (1938) and J.S. Seidman, Seidman's Legislative History of Federal Income and Excess Profits Tax Laws: 1953-
corporate reorganization definition. It ultimately succeeded only in making the definition incredibly and most (including me) would argue pointlessly complicated. But it never did much in the way of providing a raison d'être. Thus, notably, the most famous elaboration of a raison d'être is one official's unofficial pronouncement, famously broadcast in the New York Times. A.W. Gregg, a special assistant to Treasury Secretary Andrew Mellon, stated that the purpose of the reorganization provisions was to ensure that exchanges involving "merely changes in form and not in substance" should not be taxed.4

Both the "purely paper transactions" language and the "merely changes in form and not in substance" language are open to a very natural and very narrow interpretation. Under this interpretation, Congress did not intend to add any taxpayer benefit not already provided by the underlying constitutional tax law (as understood by Congress). That constitutional tax law limited income taxation to income that was realized. Congress may have believed, but may have feared that the Commissioner and the courts would not similarly believe, that some purely paper transactions and mere changes in form did not amount to realization. Accordingly, it enacted the reorganization provisions as a sort of insurance policy, a backstop to the Constitution.45 Was Congress just being paranoid? As it turns out, it was not. The Commissioner and certain Justices on the Supreme Court did indeed ultimately take a much narrower view of what did and what did not amount to realization.

For example, in *Eisner v. Macomber*, Justices Brandeis and Holmes attempted, unsuccessfully, to persuade their colleagues that the ultimate purely paper transaction, the mere splitting of a corporation's stock, should constitute a (taxable) realization event.46 And in *Marr v. United States*, Justice Brandeis, now writing for the majority, stated that a New Jersey corporation's reincorporation as a Delaware corporation was a (taxable) realization event because "a corporation organized under the laws of Delaware does not have the

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45 See Bank, supra note 40, at 43–78; see also ALI PROJECT, supra note 18, at 155.

same rights and powers as one organized under the laws of New Jersey." I very much doubt that he could have found a single human shareholder, then or now, who would characterize such a reincorporation as anything other than the merest change in form.

But while the genesis of the reorganization provisions may well have been simply to bolster the realization principal, their effect was always much more. Thus, they have always applied to a wide swath of transactions that, while they may solely involve exchanges of paper and thus linguistically constitute "purely paper transactions," are surely much more than "merely changes in form and not in substance." If there is a valid principal, economic or otherwise, that unites these favored transactions, Congress has never seen fit to announce it. And that has left it up to commentators and courts to fill the breach. Not surprisingly, many of these have posited the justifications, briefly discussed in the prior part, that also apply in non-corporate acquisition contexts.

The first justification, adapted from the like-kind exchange context, is valuation difficulty. In certain corporate acquisitions, such as Acquisition #2, such difficulty may actually exist. But for many acquisitions that fall squarely within the corporate reorganization definition, including Acquisition #1, the notion of valuation difficulty is a joke. The second, adapted from the installment sale context, is insufficient liquidity to allow the taxpayer to pay his tax.


48 Phrased somewhat differently, no human shareholder in his capacity as a shareholder is likely to care about the identity of the state of incorporation. Corporate managers may care, but in their capacity as managers, rather than as shareholders.


50 See, e.g., Brauner, supra note 13, at 12. This is ultimately a problem for reasons of efficient tax administration. Thus, in the case of an exchange of properties that are not readily traded, one can imagine significant expenditures on appraisals and the like caused by the fact that the taxpayer will inevitably view the properties as being of little value while the Service will inevitably view the properties as being of great value. Given this waste of resources, one could argue that it may be simpler and more equitable to simply defer taxation.

51 See, e.g., ALI PROJECT, supra note 18, at 157; Brauner, supra note 13, at 13. In order for this to be a problem, two things must be true: the asset received by the taxpayer must itself be illiquid and the taxpayer must have no separate store of liquid assets with which to pay any tax on his gain.
may actually exist. But for many acquisitions that fall squarely within
the corporate reorganization definition, including Acquisition #1, there is no illiquidity. Moreover, even where liquidity is a valid
concern, mechanisms could be enacted to allow the Treasury to
effectively lend the taxpayer the cash with which to pay his tax.\footnote{See I.R.C. § 453A.}

A third justification, adapted to the reorganization context from
the realization context, and thus arguably more in tune with the
genesis of the reorganization provisions, is that most taxpayers think it
is grossly unfair to be taxed on gain from an investment prior to their
disposition of such investment.\footnote{See, e.g., Brauner, supra note 13, at 16. Of course, if current law were otherwise, it is conceivable that this perception would be different.} In large part this is because what goes up may also come down: an unrealized gain might evaporate prior to the asset’s disposition. Of course, the very same argument can be
made in a reinvestment context (and would need to be made to
provide Acquisition #1B with nonrecognition treatment): if $H$ sells $X$
for cash and reinvests his proceeds in $Y$ (or $GE$), he might suffer a loss
in $Y$ (or $GE$) that offsets some or all of his prior (taxed) gain in $X$. However, while perceptions of unfairness are strong against imposing
a tax in the investment context, they are not generally similarly strong
against imposing a tax in the reinvestment context.

The realization or fairness justification may be adapted to the
corporate acquisition context by asking the question: When will a
taxpayer view both his original $X$ stock and the consideration he
receives in exchange for such $X$ stock as constituting a single
investment? While there may be no universal answer to this question,
 attempts at answers explain at least some of the contours of the
current reorganization provisions.\footnote{See, e.g., ALI PROJECT, supra note 18, at 158.} For example, the Treasury itself
has asserted (albeit without historical support) that it is the fairness
justification that lies at the bottom of a host of nonrecognition
provisions, including specifically the corporate reorganization
provisions: “The underlying assumption of [the corporate
reorganization provisions] is... that the new enterprise, the new
corporate structure, and the new property are substantially
continuations of the old still unliquidated.”\footnote{Treas. Reg. § 1.1002-1(c) (1960).} And it has further elaborated, albeit with a narrowing caveat: “The purpose of the
reorganization provisions of the Code is to except from the general
rule [of income recognition] certain specifically described
exchanges... which effect only a readjustment of continuing interest in property under modified corporate forms.\textsuperscript{56} In other words, the taxpayer still owns his original investment.

But what does it mean for H's consideration to be substantially a continuation of his X stock (per the first quote), or a continuing interest in his X stock under a modified corporate form (per the second quote)? The tautological answer, supported by the narrowing caveat (emphasized by my added italics) in the second quote, is: it means whatever section 368 says it means. But given the inconsistencies found in current law, that answer is as unprincipled as it is unhelpful. The better answer, I think, is that H must at a minimum continue to possess an ownership interest, however indirect and attenuated, in at least some of the former assets or business of X. Such a requirement has in fact been implemented by the so-called "continuity of business enterprise" regulations, albeit as one of many requirements for nonrecognition treatment rather than as a be-all-and-end-all.\textsuperscript{57} Note that as a be-all-and-end-all, it would not serve to distinguish between Acquisitions #1 and #2. In each, H retains an indirect and either greatly or somewhat attenuated interest in the former assets or business of X.\textsuperscript{58}

VI. THE AMERICAN LAW INSTITUTE PROPOSAL AND OTHER ACADEMIC PROPOSALS

Among proposals to rationalize the taxation of reorganizations and other corporate acquisitions, the best known is surely the American Law Institute's Proposal D1 — Exchange of Stock for Stock of an Acquiring Corporation pursuant to which H would not be taxed either in Acquisition #1A (he would, however, be taxed in Acquisition #1B) or in Acquisition #2:

No gain or loss shall be recognized by any noncorporate shareholder if stock of an acquired corporation is, in

\textsuperscript{56} Treas. Reg. § 1.368-1(b) (2007) (emphasis added).

\textsuperscript{57} Treas. Reg. § 1.368-1(d) (2007). In addition, the reform proposal D1 recommended by the ALI essentially takes this approach. See ALI PROJECT, supra note 18, at 167.

\textsuperscript{58} The ALI Project included but did not recommend a proposal that would distinguish between the two acquisitions, taxing only Acquisition #1. ALI PROJECT, supra note 18, at 159–63, 182.
pursuance of the plan of acquisition, exchanged solely for stock of one or more acquiring corporations.\textsuperscript{59}

There is a curious aspect to the ALI’s proposal. Its grant of nonrecognition treatment is not premised on any single unifying theme, such as concern about valuation or taxpayer liquidity or the unfairness of taxing a substantial continuation of an investment. To be sure, each of these potential justifications is mentioned, as are others.\textsuperscript{60} And much is also made of the unnecessary complexity of the law.\textsuperscript{61} But in the end, the reader is left with the sense that the overriding reason why the ALI recommended keeping a nonrecognition provision in the context of corporate acquisitions is historical: the Code has contained such a provision almost since the inception of the income tax.

Given this non-reason for continuing nonrecognition treatment, albeit in some modified and vastly simplified form, it is not surprising that academic commentators have not in general rallied behind the ALI’s proposal. Perhaps the most withering attack on nonrecognition treatment came from David Shakow, who proposed a tax system in which all mergers and acquisitions are fully taxed (immediately, and twice).\textsuperscript{62} His justification was primarily simplification. He saw no significant countervailing consideration: “Reducing the number of nonrecognition provisions generally simplifies the application of the Code by narrowing the area in which complicated tax planning can go

\textsuperscript{59} See ALI PROJECT, supra note 18, at 167.

\textsuperscript{60} Id. at 155–59. One additional potential justification is that a grant of nonrecognition treatment may remove an impediment to business transactions that are otherwise desirable. This is an efficiency argument: nonrecognition treatment can be used to overcome the so-called lock-in effect. It is worth noting that scholars are now quite skeptical of this argument. See Brauner, supra note 13, at 17–49; Shaviro, supra note 16, at 55–58. Another potential justification is that reorganizations are primarily corporate transactions, rather than shareholder transactions. This argument has two forms. First, reorganizations can often be carried out without the consent of and indeed over the objection of individual shareholders. In such cases, it is unfair to tax the shareholder on an involuntarily realized gain. Second, a corporate reorganization or other acquisition is not a necessary prerequisite to the complete divestiture of a shareholder’s interest in a corporation’s businesses: the corporation can simply sell all of its businesses and enter into new businesses; the shareholder is not taxed because he did not sell, exchange or otherwise dispose of his shares. If such a complete divestiture is possible without the imposition of a shareholder-level tax, then why should lesser divestitures of the sort that arise in reorganization contexts lead to recognition?

\textsuperscript{61} Id. at 155, 163–67.

on. Accordingly, transactions should be taxable unless such a change will substantially restrict normal economic activity.\textsuperscript{63}

Just as it is relatively easy to design a generally consistent tax regime that places a heavy thumb on the scales in favor of nonrecognition, it is relatively easy to design a generally consistent tax regime that places a heavy thumb on the scales in favor of recognition. The former type of regime must be grounded on a proposal very like that of the ALI: it will necessarily grant nonrecognition treatment to any shareholder who exchanges target corporation stock for purchasing corporation stock because such shareholder would have received nonrecognition treatment (albeit as the result of the lack of realization) had the acquisition instead been structured as the acquisition of the purchasing corporation by the target corporation. (Acquisitions #2A and #2B illustrate the ease with which corporations that are parties to an acquisition can reverse roles.)

The latter type of regime, meanwhile, would probably approach mark-to-market taxation. The reason can be illustrated by reference to Acquisition #1. If the Code is bereft of corporate reorganization provisions, then $H$ is taxed when $GE$ acquires $H$'s $X$ stock in exchange for $GE$ stock. But consistency then demands that $H$ must be taxed even if the transaction is restructured so that $X$ acquires all of $GE$'s stock in exchange for newly issued $X$ stock (the classic example of a minnow swallowing a whale). But in the absence of any corporate reorganization provisions, such an acquisition of $GE$ by $X$ would result in all of $GE$'s shareholders being taxed. It then follows that such shareholders must be taxed even if $GE$ acquires $X$.

Thus, a tax regime that entirely abolishes anything like the corporate reorganization provisions and also insists on consistency must tax all of the shareholders of both the target corporation and the purchasing corporation, at least in the case of an acquisition making use of stock as consideration. Accordingly, under such a tax regime, stock acquisitions would never occur — $GE$'s shareholders would not stand for being taxed every time $GE$ made a stock acquisition, however small — unless they did not recognize any incremental gain as a result of such acquisition. The only way that they uniformly would not recognize any incremental gain would be that they have no incremental gain to recognize. And that, in turn, would only be possible if they have already recognized all of their gain, even in the absence of a stock acquisition. The tax regime that ensures that they have indeed recognized all of their gain, even in the absence of a stock

\textsuperscript{63} Id. at 191.
acquisition, is mark-to-market taxation. The realization principle, in other words, would be dead.

While Shakow is no fan of nonrecognition treatment, he does not base his corporate reorganization reform proposal on a wholesale abandonment of the realization principle. Rather, he chooses to occupy an intermediate position, making some but not all corporate reorganizations and other acquisitions taxable. To occupy such a position, and yet satisfy the demands of consistency, Shakow seeks robust definitions of what constitutes a target corporation and what constitutes a purchasing corporation. Once those robust definitions are in hand, he gives them consequences. The consequence of being the target is that the target’s pre-transaction shareholders are taxed on all of the gain or loss with respect to their target stock; the consequence of being the purchaser is that the purchaser’s pre-transaction shareholders are not taxed on any of the gain or loss with respect to their purchaser stock.

How does Shakow robustly identify the target and the purchaser? He looks to post-transaction ownership. If a corporation’s equity ownership has changed by more than 50% (which must be true for one and only one of the two corporations involved in any reorganization or other corporate acquisition, except in the unusual case in which each corporation’s equity ownership changes by exactly 50%), such corporation is treated as the target. If a corporation’s equity ownership has changed by less than 50%, such corporation is treated as the purchaser.

Thus, in Shakow’s model, $H$ would be taxed on Acquisition #1 whether it is structured as an acquisition of $X$ by $GE$ (as it is under either Variant 1A or Variant 1B) or even as an acquisition of $GE$ by $X$. And $H$ would not be taxed in Acquisition #2, whether it is structured as in Variant 2A as an acquisition of $X$ by $RUC$ or as in Variant 2B as an acquisition of $RUC$ by $X$, since, in either case, pre-acquisition $X$ and $RUC$ shareholders will each own exactly 50% of the

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64 He does make that argument elsewhere, however. See Shakow, supra note 13.
65 Id. at 194–95. Note that since Shakow is also concerned about taxation at the corporate level, he uses this very same criterion to determine which of the two corporations (if either) is taxed on the gain or loss with respect to its assets. Id. at 195.
66 Id. at 194–95. While not stated in the clearest of terms, it would appear that Shakow would also treat a corporation as a target if more than 50% of its assets change in a relatively short time frame. See id. at 195. Thus, for example, if a corporation sells just over 50% of its assets and reinvests the proceeds in a new business, Shakow would treat the corporation’s shareholders as having disposed of their stock in a taxable transaction. See id.
equity of the surviving corporation. Finally, note that for Shakow, everything turns solely on the question of which corporation is the target and which is the purchaser; nothing at all turns on such historically critical notions as valuation, liquidity, and the like.

More recently, Yariv Brauner has argued for doing away with nonrecognition treatment in the context of reorganizations and other corporate acquisitions.\(^6^7\) Brauner notes that empirical evidence supports the proposition that corporate acquisitions involving cash consideration (and which are therefore taxable under current law) are no less and probably actually more efficient (in the sense of wealth-creating) than corporate acquisitions involving stock consideration.\(^6^8\) Indeed, the latter are likely not efficient (in the sense of wealth-creating) at all. If these propositions are correct, then current tax rules are not inhibiting efficient transactions, but are likely encouraging inefficient ones. At a minimum, they should cease doing the latter.

In order to ensure that the tax law does not favor corporate acquisitions involving stock consideration, Brauner would repeal the section 368 reorganization provisions.\(^6^9\) Thus, every corporate acquisition, however structured, would be taxable. Unfortunately, tax would only be imposed on parties who experience a realization event, since Brauner does not argue for repeal of the realization requirement.\(^7^0\) Thus, \(H\) would be taxed in Acquisition #1, whether carried out by means of Variant 1A or Variant 1B (but not if carried out by having \(X\) swallow \(GE\)). Moreover, \(H\) would be taxed in Acquisition #2A, but not in Acquisition #2B, since the latter does not produce a realization event for \(H\). Note that Brauner, like Shakow, would not allow tax results to depend on such niceties as valuation or liquidity.

\(^6^7\) Brauner, supra note 13.

\(^6^8\) Id. at 47.

\(^6^9\) Id. at 50.

\(^7^0\) Id. at 51. In fairness, Brauner's avowed agreement with Shakow's approach means that he may well endorse such repeal, but he does not make such a grand proposal in his article.
If one is interested in serious tax reform, it is easy to dismiss Brauner's proposal, since it does not satisfy the threshold consistency requirement that substance rather than form should determine tax consequences. Accordingly, parties would continue to expend significant energy determining which form of transaction will result in the least amount of tax. One could ask if it is possible to resurrect Brauner's proposal. The answer has already been stated above. A consistent tax regime that mandated recognition for corporate reorganizations would need to repeal the realization principle at least as currently applied to shareholders of corporations that acquire other corporations in exchange for stock.

VII. CHOOSING FROM THE MENU OF CONSISTENT TAX TREATMENTS

A. The Spectrum of Choices

From the foregoing discussion, it should be clear that there are a number of consistent ways in which to tax corporate acquisitions or combinations, and that these ways span a spectrum ranging from those that generally favor nonrecognition treatment to those that generally favor recognition treatment. The following table repeats the choices.

<table>
<thead>
<tr>
<th></th>
<th>Acquisition #1</th>
<th>Acquisition #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Law</td>
<td>Not taxable (A) and taxable (B)</td>
<td>Taxable (A) and not taxable (B)</td>
</tr>
<tr>
<td>Shakow</td>
<td>Taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td>Brauner</td>
<td>Taxable</td>
<td>Taxable (A) and not taxable (B)</td>
</tr>
<tr>
<td>ALI Project</td>
<td>Not taxable (A) and taxable (B)</td>
<td>Not taxable</td>
</tr>
</tbody>
</table>
### TABLE 6. CONSISTENT TAX TREATMENTS

<table>
<thead>
<tr>
<th>Tax Treatment</th>
<th>Acquisition #1</th>
<th>Acquisition #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecognition if any nonstock consideration is reinvested in stock</td>
<td>Nontaxable</td>
<td>Nontaxable</td>
</tr>
<tr>
<td>Nonrecognition if any nonstock consideration is reinvested in stock, but only if such consideration is involuntarily received</td>
<td>Nontaxable (A) and taxable (B)</td>
<td>Nontaxable</td>
</tr>
<tr>
<td>Nonrecognition if stock consideration is received (ALI)</td>
<td>Nontaxable (A) and taxable (B)</td>
<td>Nontaxable</td>
</tr>
<tr>
<td>Nonrecognition if insufficient change in effective ownership of corporation's shares (Shakow)</td>
<td>Taxable (at 50%)</td>
<td>Nontaxable (at 50%)</td>
</tr>
<tr>
<td>Recognition whenever corporation engages in a stock-based business combination</td>
<td>Taxable</td>
<td>Taxable</td>
</tr>
<tr>
<td>Mark-to-market</td>
<td>Gains already taxed</td>
<td>Gains already taxed</td>
</tr>
</tbody>
</table>

The first three options in the table are all relatively permissive. The most permissive option follows the general approach of the qualified stock rollover: any shareholder who receives cash (or other nonstock) consideration as a result of a corporate acquisition would be entitled to nonrecognition treatment so long as he reinvested such cash, during some suitably short window (e.g., sixty days), in any other corporate stock of his choice. The next most permissive option follows the general approach applied by the Code to involuntary conversions, and thus allows a nonrecognition rollover of cash consideration only when a shareholder is divested, against his will (as generally manifested by his vote), of his corporate stock. The final and least permissive of the permissive options is that of the ALI: a shareholder is granted nonrecognition treatment so long as he

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71 See I.R.C. § 1033.
receives consideration consisting solely of stock.

Note that I call each of these tax treatments "consistent," in spite of the apparent inconsistency that can be seen in the first column of the table. This is because such tax treatments are consistent so long as one ascribes substantive significance to a shareholder's (even very temporary) receipt of cash. Ascribing such substantive significance is by no means irrational, since the even very temporary receipt of cash opens the door to a wide array of investment and consumption choices. Nonetheless, since it is possible that such inconsistency would be exploited by taxpayers seeking to accelerate losses, it may be that the most permissive option should be preferred as the one that is "most consistent." On the other hand, it is less than clear, at least in the public company context, that any significant amount of exploitation would occur.

The intermediate options, and there are an infinite continuum of such options, follow Shakow. In essence, these options treat diversification as a possible realization event, and hence as a possible trigger for recognition. Shakow's actual proposal set the diversification threshold at more than 50%; if as a result of a corporate acquisition, one corporation's shareholders own less than a 50% equity interest in their corporation or the successor to their corporation, they are taxed. But there is no necessary reason to set the threshold at "more than 50%." Thus, one could as easily and as coherently, albeit marginally more arbitrarily, set the threshold at, for example, more than 40%: if as a result of a corporate acquisition, one

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72 Note that even this option is not entirely consistent. However, it is not the interposition of cash consideration, but rather the interposition of sufficient time prior to reinvestment (e.g., sixty-one days), that would lead to recognition.

73 In the case of public companies, the decision of how to structure a corporate acquisition is generally made by a combination of the purchasing corporation and the majority of shareholders of the target corporation. The purchasing corporation may well prefer to pay cash since the use of cash has two distinct benefits. First, the use of cash, whether or not there is attendant borrowing, allows the purchasing corporation to expropriate cash flow otherwise headed to the Treasury. Second, the use of cash, particularly if there is attendant borrowing, sends a less equivocal signal to the capital markets than does the use of stock as to the purchasing corporation's assessment of the benefits of the acquisition. Meanwhile, a majority of the shareholders of any public target corporation are generally tax indifferent; they are either tax exempt entities or mutual funds (which are able to pass their gains on to their shareholders). These shareholders generally prefer to receive cash consideration, since cash is more easily valued and more easily redeployed than is stock consideration. Thus, in the public company context, considerations other than the tax posture of the human shareholders of the target corporation are likely to determine the choice of cash or stock consideration.
corporation's shareholders own less than a 60% equity interest in their corporation or the successor to their corporation, they are taxed. Note that this modification would affect the taxation of Acquisition #2: whereas $H$ would not be taxed under Shakow's actual proposal, he would be taxed under this modification.

Finally, one could, and probably should, modify Shakow's measurement criterion to one that focuses on asset ownership rather than equity ownership. That is, the true extent to which $H$ has modified his investment is not determined by post-combination equity ownership, but rather by post-combination asset ownership. For example, in Acquisition #2, although $X$'s shareholders continue to own a 50% equity interest in their pre-combination assets, their pre-combination assets only comprise 37.5% of the total value of their post-combination investment. Thus, they have diversified their investment by more than 50%. A rule based on assets might read as follows: if as a result of a corporate acquisition, one corporation's shareholders indirectly own assets of which less than 50% constitute pre-acquisition assets, they will be taxed. Under this rule, $H$ would be taxed in Acquisition #2, however structured.

Moving out of the realm of intermediate options and into that of pro-recognition options, the first possibility would be essentially Brauner's proposal made consistent by taxing not only those parties to a corporate acquisition who experience a classic realization event but also those parties to a corporate acquisition who do not. Thus, for example, in Acquisition #1, not only would $H$ be taxed, but so would all of $GE$'s shareholders. Such a rule, while consistent, could be expected to bring to a screeching halt all corporate acquisition activity making use of stock as consideration. The $GE$s of the world would simply not be able to foist such recognition on their shareholders. Thus, any attempt to move to the full recognition rule should at least lead one to consider a further move to mark-to-market taxation. Under such a regime, corporate acquisitions making use of stock as consideration could once again proceed unimpeded by tax considerations. Since all gains and losses would be realized and recognized as they occur, an actual corporate acquisition would not lead to incremental taxation of either the target corporation's or the purchasing corporation's shareholders.

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74 Shakow more or less acknowledges this. See Shakow, supra note 62, at 195–96.
B. Intermediate Options

Intermediate options have two features that recommend them. First, by taking only part of a loaf, they necessarily leave part of a loaf. The true believer in nonrecognition will deprecate the taking, but will find a tad of solace in the leaving. The true believer in full and immediate recognition will do the opposite. But it is at least possible that each will rally behind an intermediate option if it is sufficiently clear that their preferred extreme option is unlikely to be adopted.

Second, intermediate options have the aura of scientific precision about them. In Shakow's version, it is possible, at least under certain sets of facts, to say with precision that one corporation is the target, that the other is the purchaser, and that those categories are independent of the actual corporate machinations. In a more generalized version, it is theoretically possible to say that a shareholder's investment represented by his shares of a corporation's stock has been altered by z%. If the alteration is sufficiently great, it is proper for the tax law to treat the shareholder as now owning shares in a new and different corporation, and thus as having engaged in an exchange of the original shares for the new shares.

Of course, applying intermediate options may prove difficult in practice. If all relevant corporations have only shares of common stock outstanding, it is easy to measure the impact of a corporate acquisition on the original shareholders' interest in their corporation's underlying assets. For example, in Acquisition #1, the shareholders of X (i.e., H) owned 100% of the shares of X before its combination with GE, and own 0.00025% of GE's shares after the combination. Thus, such shareholders' participation in X's original assets falls by an objectively measurable 99.99975% from 100% to 0.00025%.

But what if the corporations involved in the business combination have multiple classes of stock outstanding, each with different entitlements? In this case, Shakow's apparently objective focus on group ownership becomes problematic for at least two reasons. The first is that such focus does not, in fact, eradicate the relevance of transactional form. The second is that it may make valuation questions, which are all but unanswerable, determine the tax outcome.

To see how transactional form could change the tax results in Acquisition #2, suppose that the transaction proceeds essentially as in Variant 2B, but with the following changes. First, X does not borrow any money from Bank, and accordingly does not engage in a recapitalization. However, X does amend its charter to provide that the Class A and the Class B stock will henceforth each be entitled to
only a single vote per share. Thus, at the time of the merger of *RUC* with and into *X*, *X* continues to have 500,000 shares of Class A Common Stock (now having one vote per share) and 500,000 shares of Class B Common Stock outstanding. The merger takes place as before, with each share of *RUC* being exchanged for one share of *X*'s Class B Common Stock. Thus, after the merger, *X*'s original shareholders own all 500,000 shares of *X*'s Class A Common Stock and 500,000 out of 1.5 million shares of *X*'s Class B Common Stock. Note that so long as the Class A Common Stock's liquidation preference stays "in the money," there is no significant difference between the economics of this transaction and the economics of the original Acquisition #2. For example, after waiting a suitable period of time, *X*'s Class A Common Stock could be recapitalized as in the original Acquisition #2, thus exactly restoring the economics of the original structure.

How would Shakow's scheme tax this new variant? Let me stipulate that the post-combination fair values of the Class A and Class B Common Stock are $50 per share and $10 per share, respectively. If so, then *X*'s original shareholders own 75% of the post-merger corporation, and *RUC*'s original shareholders own the remaining 25%. In other words, *X* has become the purchasing corporation and *RUC* has become the target corporation. Accordingly, Shakow would not tax the original shareholders of *X*, but would tax the original shareholders *RUC*. Form, it turns out, matters very much indeed!

The second problem, which is admittedly not a problem of theory but merely of administration, arises from the difficulty of valuing stock in the absence of public equity markets. For example, consider the following variation of Acquisition #2. Suppose that *X* has among its assets the rights to drill for oil on a patch of land called *Parcel V*. *X*'s shareholders believe that *Parcel V* will be particularly lucrative, but *RUC*'s shareholders are somewhat skeptical. Further, suppose that *RUC* has among its assets the rights to drill for oil on a patch of land called *Parcel W*. *RUC*'s shareholders believe that *Parcel W* will be particularly lucrative, but *X*'s shareholders are somewhat skeptical.

Under these facts, a business combination between *X* and *RUC* (which might still make an extraordinary amount of sense due to factors such as cost savings, diversification of projects, etc.) might proceed along the general lines of Acquisition #2A, but with the following modifications. *RUC* amends its charter to provide for two classes of common stock. The first class, called Class W, entitles its owners to a modest preferred return based on a fraction of the net
cash generated by Parcel W, and otherwise entitles them to participate equally with owners of all other classes of RUC common stock in all other distributions and liquidation proceeds. The second class, called Class V, entitles its owners to a modest preferred return based on a fraction of the net cash generated by Parcel V, and otherwise entitles them to participate equally with owners of all other classes of RUC common stock in all other distributions and liquidation proceeds. Once the charter has been amended, X merges with and into RUC. The original owners of RUC’s common stock exchange each share for one new share of Class W Common Stock. Finally, X’s Class A Common Stock owners exchange each share for $40 in cash and one new share of Class V Common Stock; X’s Class B Common Stock owners exchange each share for one new share of Class V Common Stock.

Confronted with these facts, how would Shakow’s tax regime respond? Is X the purchasing corporation? Its original shareholders clearly think so. But RUC’s original shareholders just as clearly think that X is the target corporation. The Commissioner, predictably, will argue that X and RUC are each target corporations. Intractable valuation questions have thus been elevated to tax outcome determinative status. That can’t be good.

Two questions must be answered before surrendering all hope in intermediate options. First, are the infirmities identified above likely to be sufficiently important to matter? Second, are there ways to modify the Shakow-style intermediate option that do not suffer from the same infirmities?

The first question is largely empirical. As an empirical matter, I concede that the problem, at least in the public company context, is unlikely to be significant. In that context, which admittedly is Shakow’s focus (in large part because it is the only context in which valuation issues are not insuperable), corporations with multiple classes of stock exist, but are in the distinct minority. Moreover, in vanishingly few of the corporate combinations involving corporations with multiple classes of stock are such multiple classes likely to cast any doubt on the identity of the target corporation and the purchasing corporation.

Nonetheless, a robust tax regime should be concerned not only with the public company context, but also with the private company context. Anecdotal evidence based on my prior life in practice suggests that multiple classes of stock are quite common in the context of private companies. Moreover, the same anecdotal evidence suggests that shareholders transacting in the private company context

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are far more amenable to complicating their corporate capital structures with multiple classes of stock if such complications produce desired tax savings. Perhaps this is as it should be. Perhaps it is socially desirable to allow private company shareholders a wider latitude for avoiding recognition than public company shareholders. After all, these are the fabled small businessmen, the principals of venture capital and private equity firms, and so on, who are surely the actors in the economy who are the most responsive to tax incentives. These are also the same individuals who so disproportionately populate the upper classes. It therefore seems to me that a policy debate beyond the scope of this article (and beyond the scope of Shakow's article as well) is necessary before pronouncing that a problem of multiple classes of stock is insignificant.

But suppose one takes the other position: that the problem of multiple classes of stock is both empirically and conceptually unimportant. After all, even if private company shareholders can manipulate the preferences of different classes of stock and thus designate either party to a corporate combination to be the purchasing corporation, their machinations will (in all but the rarest cases) leave the other party to the combination as the target corporation. As a result, exactly one set of shareholders will (almost) always still be taxed. Does this mean that all is well in a Shakow-style world?

Alas it does not. The Shakow-style tax regime has another and considerably more important conceptual flaw. What determines taxation under Shakow is the presence or absence of an ownership change. For example, in Acquisition #2, Shakow would not tax \( H \) because \( H \) is one of \( X \)'s original shareholders and such shareholders as a group own 50% of the surviving corporation (whether \( RUC \) as in Variant 2A or \( X \) as in Variant 2B). This is nothing more than a type of continuity-of-interest inquiry, and thus must succumb to all of the problems that plague such an inquiry. In particular (and exactly as under current law), \( H \)'s taxation would depend not on the economic characteristics of his own exchange, but on the economic characteristics of the aggregation of the exchanges of all of \( X \)'s shareholders.

To see how this may matter under specific facts, consider yet another variant of Acquisition #2. The combination will follow the general outlines of Variant 2A, but with the following differences. Suppose that the Class A shareholders of \( X \) do not merely want $40 per share of cash consideration, but actually want to be cashed out entirely. Thus, \( RUC \) must find an additional $5 million of cash beyond
the $20 million it will in any event borrow from Bank. To raise this
cash, RUC seeks an additional equity investment from its original
shareholders. Some subscribe and some don’t. But in the end, RUC’s
capitalization increases to 1.5 million shares of common stock and its
war chest increases to $25 million of cash.

The merger now proceeds apace. X merges with and into RUC,
and X’s Class A shareholders each receive $50 per share of cash
consideration; X’s Class B shareholders, including H, receive one
share of RUC common stock for each of their shares of X’s Class B
Common Stock. Thus, after the combination, H owns exactly the same
thing that he owned in Acquisition #2A: 5% of the outstanding equity
of RUC. Moreover, RUC has exactly the same assets and the same
capitalization in each case. However, under a Shakow-type analysis, X
is now the target corporation (its shareholders own only 25% of the
surviving corporation) and RUC is now the purchasing corporation (it
shareholders own 75% of the surviving corporation). Accordingly, all
of X’s shareholders, including H, are taxed on all of their gain. This
result is not only unfair — it is completely arbitrary. The fact that H,
who engages in a single course of economic conduct, is sometimes
taxed and is sometimes not, irrefutably demonstrates the lack of any
sound theoretical underpinning for this tax mechanism.

Is there any way to fix the Shakow-style regime, or create a robust
alternative intermediate option from the ground up? I do not think
either of these is possible in the absence of a clear answer to the
question: what exactly is an intermediate tax regime seeking to
accomplish? Consistency, sure. But not consistency for its own sake,
since there are extreme options — universal nonrecognition and
universal recognition — that are also consistent. Rather, an
intermediate option by definition seeks to sort the entire universe of
corporate combinations into two categories: those in which something
sufficiently significant happened to warrant taxation, and those in
which it did not.

What, as a purely conceptual matter, should constitute
significance? Shakow does not provide a clear answer, and that is
what leads him astray. Two further examples will illustrate the
quandary. First, suppose that H is a human shareholder who owns
25% of the only class of X stock and J is a second human shareholder
who owns the remaining 75% of X’s stock. If J sells all of his X stock
to K, a third human, should H be taxed? Under the facts, X has
experienced a 75% ownership change, but it has experienced such
change without experiencing any accompanying change in its assets.
While Shakow does not explicitly address this fact pattern, I do not
think he would impose tax on $H$.

Second, suppose that $H$ and $J$ own all of the stock of $X$, exactly as above, and that $X$ is unleveraged. Suppose $X$ borrows an amount equal to three times its entire net worth from $Bank$ and uses the proceeds to purchase a new (possibly corporate) business. Should $H$ be taxed? Under these facts, the assets underlying $H$'s $X$ stock have significantly changed; fully 75% of such assets are new. But the change in $H$'s indirectly owned assets has not been accompanied by any change in $X$'s ownership. Once again, although Shakow does not explicitly address this fact pattern, I do not think that he would impose tax on $H$.

Thus, while neither a stand-alone change in a corporation's assets nor a stand-alone change in its ownership is or even can be sufficiently significant to trigger recognition, a combination of such changes can be. This result is not defensible. In order to design a defensible intermediate option, one which can deal with fact patterns such as the two immediately above, I will fill the theoretical void by offering my own definition of significance.

Significance for tax purposes must be an economic concept. What matters to a human shareholder, $H$, of $X$ corporation is neither the corporate name that $X$ plasters on his shares of stock, nor (except in rare cases) the names of the other human and nonhuman owners of $X$'s stock, but rather the economic characteristics of the assets (and/or businesses) that $H$'s shares represent. Thus, if a tax regime seeks to tax $H$ on the basis of something that matters, it should focus exclusively on events that affect $H$'s interest in the assets of $X$. What are such events? The most obvious are events that actually change the assets that $X$ owns.\footnote{In addition, $X$ can engage in transactions that do not affect its actual asset mix, but simply its capital structure. Thus, $X$ can issue new equity and use the proceeds to retire debt, or it can borrow and use the proceeds to repurchase some of its equity. In each of these cases, $H$'s post-event shares will continue to represent an interest in exactly the same assets as before (for the simple reason that $X$ has neither bought nor sold any assets). But the nature of the interest will be different. For example, in the case of an issue of new equity, $H$ will participate to a lesser degree in any increase in the value of $X$'s original assets, but will not go under water as quickly in the event of a decrease in the value of such assets.

Finally, $H$ can also engage in transactions other than selling shares of $X$ that will affect his indirect interest in $X$'s assets. For example, $H$ can sell a call option against his or her $X$ stock. Such a sale is effectively a dilution of $H$'s interest in $X$'s assets accompanied by a new investment in whatever assets are acquired with the option sale proceeds. Alternatively, $H$ can pledge his or her $X$ stock as security for a loan and use the loan proceeds to purchase an alternative investment. Such a transaction also
Concentration. $X$ can sell assets and use the proceeds to retire debt, retire stock, or pay dividends. In each of these cases, $H$’s post-event shares will no longer represent an indirect interest in certain of $X$’s original assets, but will represent a more concentrated indirect interest in $X$’s remaining assets.\textsuperscript{76} From $H$’s perspective, it is as if he has exchanged his indirect interest in some assets for an indirect interest in other assets (admittedly assets in which he already had an indirect interest).

Exchange. $X$ can sell assets and use the proceeds to buy new assets of either a similar or an entirely different sort. In each of these cases, $H$’s post-event shares will no longer represent an indirect interest in certain of $X$’s original assets, will represent an unchanged indirect interest in the remainder of $X$’s original assets, and will represent a wholly new indirect interest in $X$’s newly purchased assets.\textsuperscript{77} From $H$’s perspective, it is as if he has exchanged his indirect interest in some assets for an indirect interest in other assets (in this case, assets in which he did not previously have an indirect interest).

Dilution with Leverage. $X$ can borrow and use the proceeds to buy new assets of either a sort that is similar to $X$’s existing assets or a sort that is entirely different from $X$’s existing assets. In each of these cases, $H$’s post-event shares will represent a reduced indirect interest in $X$’s existing assets (in the case of a sufficiently bad outcome for the combination of the original and the newly purchased assets, $X$ will turn over some or all of the original assets to its lenders) and a wholly new indirect interest in $X$’s newly purchased assets. From $H$’s perspective, it is as if he has exchanged an indirect contingent interest in all of his assets for an indirect interest in other assets (in which he did not previously have an indirect interest).

Dilution without Leverage. $X$ can issue new equity and use the proceeds to buy new assets of either a sort that is similar to $X$’s existing assets or a sort that is entirely different from $X$’s existing assets. In each of these cases, $H$’s post-event shares will represent a reduced indirect interest in $X$’s existing assets ($X$’s new shareholders will enjoy both a share of the upside and a share of the downside of such assets’ performance) and a wholly new, indirect interest in $X$’s

\textsuperscript{76} The same phenomenon will occur in the case of a split-off of split-up that is currently tax-deferred under section 355. I.R.C. § 355.

\textsuperscript{77} $X$ buys and sells assets all the time in the “ordinary course” of business. Although it may be difficult, one may want to differentiate such purchases and sales from those not occurring in the “ordinary course” of business.
newly purchased assets. From $H$’s perspective, it is as if he has exchanged an indirect proportional interest in all of his assets for an indirect interest in other assets (in which he did not previously have an indirect interest).

Note that in each of these circumstances, the transaction, from $H$’s perspective, is exactly the same: $H$ “exchanges” an indirect interest in some or all of the assets he originally owns (either some but not all of those assets are disposed of in their entirety, or a contingent or proportional undivided interest in all of those assets is disposed of) for an indirect interest in other assets (which may be assets in which he already owns an indirect interest, or not). Thus there cannot be any justifiable reason to impose realization on $H$ under some, but not all, of these circumstances. Nonetheless, a robust reorganization provision that imposes tax on some, but not all, reorganizations, would attempt to do precisely that. Such a provision would single out the fourth pattern above for taxation (assuming further that the corporation’s assets changed to a sufficiently great degree), while leaving the other patterns untouched.

Would it be possible to impose realization on $H$ under any of the foregoing patterns, provided only that $X$’s assets change to a sufficient degree? It would be difficult, to say the least. First, a number of threshold questions would need to be addressed, such as whether it is appropriate to ignore passive assets, or asset sales and purchases that occur in the ordinary course of business, or subsequent sales of newly purchased assets (since they do not constitute sales of an original asset), and so forth.

Second, however such questions are answered, $X$ would need to keep a separate record and perform a separate calculation for each shareholder. This is somewhat analogous to the records and calculations generally required in the publicly traded partnership context, but now imposed on all entities irrespective of their size, the number of their owners, their legal form, etc. It would certainly be possible. However, it is difficult to argue that it would be worthwhile. Indeed, Shakow very likely limited his proposal to asset changes that occur as a result of one type of readily observable event because he deemed it not to be worthwhile. Unfortunately, while such compromises may be necessary in the interest of sound tax administration, they are impossible to justify as a matter of theory.

The third, and perhaps most important consideration, is that it would be necessary to decide when a change in $X$’s underlying assets during $H$’s ownership of $X$’s shares is sufficiently great that $H$ should be deemed to have experienced a realization event. A 50% threshold
has superficial appeal, but is there really so much difference between a shareholder whose indirectly owned assets have changed by 40% and one whose indirectly owned assets have changed by 50%, so that it makes sense to tax only the latter? I hardly think so. If it is not, then there are only two truly defensible positions: either $H$ should be immediately (and therefore continuously) taxed on any change in $X$'s assets, however small, or $H$ should not be taxed on any change in $X$'s assets, however large.

C. Extreme Options

As applied to corporate reorganizations and other acquisitions, these are the two extreme options: full recognition and no recognition. The first is essentially Brauner's proposal — repeal of the corporate reorganization rules — expanded for the sake of consistency so that shareholders of corporate parties to reorganizations (or other corporate acquisitions) are taxed not only if they experience a realization event, but even if they do not. The second is essentially the ALI's proposal: shareholders of corporate parties to reorganizations (or other corporate acquisitions) are not taxed whether or not they experience a realization event, unless they end up holding nonqualified consideration, such as cash.

Taking the full recognition proposal first, what are its strengths? Just one thing, I think: it might reduce the distortions that accompany income tax deferral, at least in the corporate context. Not only would human shareholders who previously relied on corporate reorganizations be forced to ante up tax on their unrealized gains, so too would human shareholders of the surviving corporations involved in such reorganizations.

However, I am skeptical that this benefit would be realized to any significant extent. Under a full recognition regime, I would expect to see a complete halt to explicit corporate acquisition activity. If in Acquisition #1 above, not only $X$'s shareholder, $H$, but each and every one of $GE$'s shareholders was forced to recognize all of their otherwise unrealized gain, $GE$ would never acquire $X$. Rather, $X$ and $GE$ would seek transactions, short of a full-blown acquisition, that would give each party as much of what it wants as possible. Thus, $X$ might sell its assets to $GE$ (which might at least save $GE$'s shareholders from taxation, depending on how the rules are written), $X$ might lease a large fraction of its assets to $GE$, or $X$ and $GE$ might enter into some sort of partnership arrangement. Creative solutions would surely flourish.
If the benefits of full recognition are likely to be largely ephemeral, what about the detriments? These, I fear, would be all too real. First and foremost, the full recognition regime, expanded to be consistent, lacks an underlying theory. This is not, of course, Brauner’s fault, but mine. Brauner has an underlying theory: he would tax all shareholder realization events. Period. The problem with this approach is not its lack of theoretical underpinning, but its lack of consistency. The form of any given corporate transaction would be massaged so that shareholders seeking to avoid recognition would simply hold their shares. Such shareholders would not experience a realization event, and so would continue to enjoy nonrecognition in spite of Brauner. It was to fix this consistency problem that I added deemed realization to Brauner: any shareholder of a corporation involved in a reorganization-like transaction is deemed to experience a realization event, whether or not he continues to own his original shares. No nonrecognition provision is available in the event of either an actual or a deemed realization.

Unfortunately, once deemed realization is added to the mix, all of the theoretical problems discussed in the context of the intermediate taxation options emerge. In particular, there would be no theoretical reason to single out stock-based corporate acquisitions: realization would be equally appropriate for shareholders of corporations that acquired other corporations for cash, acquired such corporations’ assets for cash, or acquired noncorporate assets for cash. There is no defensible stopping point on this slippery slope, short of taxing shareholders each and every time that the corporation exchanged any asset at all. Such taxation is continuous taxation, or mark-to-market taxation. While it is quite defensible in theory, it is well beyond the extreme option envisioned by Brauner.

In addition to the lack of a theoretical underpinning, or even in the presence of such theoretical underpinning (as would be the case if full recognition were deemed to be synonymous with mark-to-market), full recognition taxation carries with it a host of problems. I count at least five, all of which have been elaborated to a greater or lesser degree above: (1) discrimination against corporate transactions in favor of noncorporate transactions, assuming that nonrecognition rules in noncorporate contexts remain unchanged, (2) probable discrimination against public company corporate transactions in favor of private company corporate transactions, assuming that full recognition is either inapplicable or differently applicable in private company contexts due to the absence of readily available valuation data, (3) taxation of shareholders in the absence of cash receipts and
perhaps even in the absence of liquidity, (4) possible taxation of shareholders in the absence of objective valuation data, and (5) taxation of shareholders in the absence of any voluntary transaction and in certain circumstances in the absence of any transaction at all, voluntary or otherwise (as would be the case if recognition applied to shareholders of both the target and the acquiring corporation, as would be demanded by consistency).

Turning at last to the only proposal still standing, the no recognition proposal, what can be said in its defense? Actually quite a lot: in particular, it does not suffer from any of the infirmities already elaborated for either an intermediate recognition regime or a full recognition regime. Moreover, it is breathtakingly simple. Finally, it is unlikely to meaningfully increase the tax-regime-based inefficiency of shareholder behavior, also known as the "lock-in" effect. The lion's share of such inefficiency is a direct result of the realization principle in its naked glory. Furthermore, neither incrementally reducing the effect of such principle by making nonrecognition randomly (from a shareholder's perspective) inapplicable to certain corporate mergers and acquisitions nor incrementally increasing its effects by making nonrecognition applicable to a broader array of corporate mergers and acquisitions is likely to have any meaningful impact on the underlying problem.  

The total size of the United States equity market is approximately $16.4 trillion. Crain Communications, Pensions and Investments (Oct. 30, 2006). The total value of United States mergers and acquisitions in 2005 was $1.0 trillion. Purchase Price ($ in Millions) 1986-2005, MERGERSTAT REV. (FactSet Mergerstat, L.L.C.), 2006, at 9. Approximately 54% of such mergers and acquisitions featured solely cash consideration, while another 25% featured a combination of cash and stock. Payment Trends 1986-2005, MERGERSTAT REV. (FactSet Mergerstat, L.L.C.), 2006, at 14. Thus, it would appear that a total of $0.8 trillion of potentially table merger consideration was paid in 2005. Even if all of this consideration was paid to purchase the stock of publicly traded companies, less than 5% of such stock was so acquired during the given year. Even in the case of a shareholder with a diversified portfolio, this amount of random unwanted recognition is unlikely to have a dramatic impact on his behavior.

Moreover, there are at least two reasons to believe that the actual share of an individual's portfolio that is likely to be annually acquired in unwanted taxable transactions is significantly lower than the 5% figure. First, the merger and acquisition statistics quoted above include transactions in which corporate businesses, but not the corporations themselves, are acquired. Thus, if a large publicly traded company sells one of its businesses, that shows up in the statistics. But that will never lead to an unwanted taxable event for a shareholder. Second, the very largest public deals tend to be stock acquisitions: the cash acquisition market simply has not developed to the point where the likes of Bell South (by AT&T), or Warner-Lambert (by Pfizer), or
Alas, once one concludes that expanded availability of nonrecognition treatment is the only defensible change to the taxation of corporate mergers and acquisitions, it is necessary to decide where to draw the line on nonrecognition. Should one, as the ALI proposed, draw the line at the receipt of consideration other than stock, making any such receipt taxable? I think not. I think that inherent in the realization principle is the notion that it should be the taxpayer's own choice that determines when he will be taxed on his gain with respect to any single investment. Thus, if a conceded realization event occurs that is not of the shareholder's choosing and, moreover, is against his wishes, such realization event should not result in the immediate payment of tax. Congress has recognized this principle in noncorporate contexts: section 1033 applies to "involuntary conversions" of property, but that provision does not include within the definition of "involuntary conversion" the "forced sale or exchange" of corporate stock pursuant to a merger or acquisition. I think that the involuntary conversion rules, or something very similar, but with a considerably shorter reinvestment window to reflect the fact that finding replacement property in the corporate equity context is generally easier than finding replacement property in the context of other types of property, should be made applicable to corporate mergers and acquisitions.

This suggestion has been made once before, albeit as a throwaway remark. That remark has been criticized by Brauner, who

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AOL (by Time, Inc.) can be acquired for cash. Thus, while the majority of deals may well be for cash, the majority of consideration is surely not cash. This, again, means that the likelihood of an unwanted taxable transaction is far lower than the statistics suggest.

The more or less obvious motivation behind the involuntary conversion provisions, which were first codified in the 1921 Act, is that it would be "unjust" to tax any gain arising from such conversions; to do so would be rubbing (tax) salt into the wound. See CLARENCE MCCARTHY, BILLY MANN & WILLIAM GREGORY, THE FEDERAL INCOME TAX: ITS SOURCES AND APPLICATIONS 396 (1971). But the truth is that the Congress had an additional, subtler motivation. Much of the early involuntary conversion activity resulted from the Federal Government's confiscation of property connected with its efforts in World War I. Taxpayers were much less likely to challenge these confiscations if they were not additionally saddled with a tax burden. See, e.g., JOSEPH KLEIN, FEDERAL INCOME TAXATION 915 (1929); cf. SEIDMAN, 1953-1939, supra note 43, at 1583 (discussing similar motivations for an expansion of then section 112(f) in light of taxpayer reluctance to play along with Federal Government acquisitions of property in connection with the defense program). Still, the involuntary conversion provisions have never been limited to involuntary conversions caused by the Federal Government.

See Ulysses S. Crockett, Jr., Federal Taxation of Corporate Unifications: A
correctly notes that the possibility of a merger or acquisition is inherent in any shareholder’s stock, and that there is accordingly no unfairness in taxing such shareholder as and when a merger or acquisition arises, regardless of whether the shareholder has consented.\textsuperscript{81} But Brauner’s argument proves too much. The possibility of destruction by fire or confiscation in an eminent domain proceeding is inherent in many types of property, but that does not make such property ineligible for nonrecognition relief under section 1033. Thus, the premise behind the current involuntary conversion provision can be none other than that it is unfair to remove from the taxpayer the unilateral right to determine when he will recognize his gain. Period. This argument has as much force when the property is common stock as when it is real property or livestock.\textsuperscript{82}

My proposal is the following: a shareholder whose stock is sold or exchanged pursuant to a merger or acquisition should be entitled to nonrecognition treatment so long as and to the extent that either (1) he or she receives stock in the acquiring corporation or (2) he or she involuntarily receives consideration other than stock in the acquiring corporation but promptly and appropriately reinvests such consideration. The first clause simply follows the ALI Project and so

\textit{Review of Legislative Policy, 15 DUQ. L. REV. 1 (1976).}

\textsuperscript{81} See Brauner, supra note 13, at 15 n.50.

\textsuperscript{82} One way in which it might be possible to attempt to distinguish the forced sale of a taxpayer’s stock from a more generic involuntary conversion of a taxpayer’s property is to note that in the former case, but not in the latter, the taxpayer is in theory being represented in the relevant transaction by his duly appointed agents – the board of directors – and should therefore be bound for all purposes, including tax purposes, by the decisions of those agents. While this argument will distinguish a forced sale of stock from the receipt of insurance proceeds following a fire, it will not distinguish a forced sale of stock from a forced sale of land pursuant to an eminent domain confiscation. The reason is that the actor in the last case, the local government, is as much an agent of the taxpayer as is his board of directors.

A second and related way in which it might be possible to justify tax discrimination against a forced sale of a taxpayer’s stock is to point out the similarity of such forced sale to the receipt of an unwanted dividend. Would I extend nonrecognition to a prompt reinvestment by a shareholder of an unwanted dividend (e.g., a reinvestment that occurs in the context of a dividend reinvestment plan)? I would not. Dividends, even extraordinary dividends, are part and parcel of an investment in corporate stock, just as rental receipts are part and parcel of an investment in real estate. Tax law frequently distinguishes such periodic cash flows and subjects them to a different tax treatment from a disposition of the entire investment (indeed, this is the basis that generally distinguishes ordinary income from capital gain). I see no reason why it should not do the same in the “involuntary receipt” context.
requires no additional explication. The second clause however requires further discussion.

First, since it is beyond the scope of this article to convert the current income tax into a cash flow or consumption tax, it is necessary to distinguish the ordinary types of stock sales and reinvestments from certain stock sales and reinvestments occurring in the mergers and acquisitions context. The former are currently taxed and would continue to be taxed under section 1001, while all, some, or none of the latter would be entitled to nonrecognition treatment. I opt for some of the latter. My reason for rejecting nonrecognition of all stock sales and reinvestments occurring in the mergers and acquisitions context is that many such stock sales are largely indistinguishable from stock sales outside such context, and should thus be taxed the same as sales outside of such context. My reason for rejecting nonrecognition treatment of no stock sales and reinvestments occurring in the mergers and acquisitions context was set forth above: it is unfair to tax a shareholder on an involuntary sale of this stock. That is why my second proposal contains the limiting word “involuntarily.”

Second, merely limiting the right to receive nonrecognition treatment to circumstances under which involuntarily received non-stock consideration is promptly reinvested does not answer the question of what is meant by “involuntarily.” I would base the determination of voluntariness on the shareholder’s actions. Thus, the shareholder would be entitled to claim that he received the resulting consideration involuntarily if he votes against the merger or acquisition, but not otherwise.

Third, nonrecognition treatment would be contingent on “prompt and appropriate” reinvestment of non-stock consideration. Since my idea is not to unduly expand the availability of nonrecognition treatment, I would structure the reinvestment requirement so that it is as narrow as practicable. Thus, if the shareholder's stock were acquired by a public company, I would give the shareholder a very short window — no more than a week — to reinvest his consideration solely in the stock of the acquiring public company. In short, I would place the shareholder in no better position than he would have been in had the acquiring company given its own stock as consideration.\footnote{Public companies frequently prefer to pay cash rather than stock. One reason for this is that a payment of cash is viewed by the market as a better signal of corporate discipline with respect to acquisitions. Another reason is that a host of shareholders, including tax indifferent shareholders and risk arbitrageurs, prefer receipts of cash.}
particular, and in keeping with the current corporate reorganization provisions, the dispossessed shareholder would only receive nonrecognition treatment if he maintained an indirect interest, however attenuated, in his original assets.

If a shareholder's stock is acquired by a privately held corporation, as would be the case in a management leveraged buyout, it is impossible for the shareholder to reinvest his consideration in such a way that he maintains an indirect interest in his original assets. But even in such case, allowing unfettered reinvestment options is unnecessary. To deal with this situation, I would propose, first that the reinvestment window be expanded, perhaps to thirty days, and second that the reinvestment choices be expanded, perhaps to the stock of any company engaged in the same business as the acquired corporation. 

VIII. CONCLUSION

In this article, I have examined human shareholder taxation in the case of mergers and acquisitions. The relevant law is currently extraordinarily complex, utterly inconsistent, and in many instances arguably unfair. There are really only two plausible ways to cure these ills. The first, to move to a tax system with more fulsome gain recognition, ultimately in the form of mark-to-market taxation, is not in my opinion technically or politically feasible. Accordingly, the second, to move to a tax system with less gain recognition, merits attention.

I propose such a tax system. In particular, under my proposal, a human shareholder whose stock is sold or exchanged pursuant to a merger or acquisition would be entitled to nonrecognition treatment so long as either (1) he receives stock in the acquiring corporation or (2) he involuntarily receives consideration other than stock in the acquiring corporation but promptly and appropriately reinvests such consideration.

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84 This last rule could be operationalized by making use of Standard Industrial Codes (SIC codes). A minimal requirement might be that the corporation whose stock is purchased with the acquisition proceeds must have as a significant business some business that belongs to the same SIC code as a significant business of the acquired corporation.