

TAX-FREE REORGANIZATIONS: THE EVOLUTION AND REVOLUTION OF TRIANGULAR MERGERS

Stephanie Hoffer & Dale A. Oesterle

ABSTRACT—Tax laws applicable to triangular mergers lack neutrality, are complex, and overlap substantially with other tax-preferred forms of corporate acquisition. Their current status is a result of both path dependency and Congress’s attempt to create consistency within a framework founded upon inconsistent conceptualizations of the corporation. This Article highlights problems arising under current rules, including a notable lack of tax neutrality among merger forms. It proposes pragmatic revisions made within the constraint of double taxation of corporate profits and then revisits the question through a more normative framework. The Article concludes that the tax treatment of target shareholders and the target corporation in corporate acquisitions should be disaggregated. Finally, it observes that both pragmatic and normative solutions proposed within the reorganization statute are unsatisfying in light of larger structural problems in the Internal Revenue Code.

AUTHORS—Dale A. Oesterle is the J. Gilbert Reese Professor of Contract Law at the Ohio State University Moritz College of Law. Stephanie Hoffer is an associate professor at the Ohio State University Moritz College of Law. We extend our sincere thanks to the *Northwestern University Law Review* for organizing this symposium, and we also thank the participants for their helpful feedback. In addition, we thank Charlotte Crane, Philip Postlewaite, Allan Samansky, and Donald Tobin for their insightful comments, our home institution for supporting our work, and Christopher Matgouranis and Robert Dodson for their capable research assistance.

NORTHWESTERN UNIVERSITY LAW REVIEW

INTRODUCTION	1084
I. VIEWING THE EVOLUTION OF TRIANGULAR REORGANIZATIONS AS A FAILED SEARCH FOR CONSISTENCY	1086
A. <i>Triangular Drop-Down, B, and C Acquisitions</i>	1088
B. <i>Triangular Mergers</i>	1091
II. OVERLAP AND INCONSISTENCY CREATE ARTIFICIAL HURDLES IN ACQUISITION PLANNING	1095
A. <i>Advantages of Triangular Mergers</i>	1095
B. <i>Triangular Merger Rules Are Complex and Lack Tax Neutrality</i>	1096
III. A PRAGMATIC RESPONSE	1099
A. <i>Important Predecessor Proposals</i>	1099
B. <i>Decoupling Shareholder Nonrecognition from Target Nonrecognition</i>	1101
C. <i>Nonrecognition of Target Gain and Loss</i>	1104
IV. A NORMATIVE RESPONSE	1107
A. <i>Prioritizing the Entity View</i>	1108
B. <i>Focusing on Realization</i>	1109
C. <i>Placing Substance over Form</i>	1111
CONCLUSION	1112

INTRODUCTION

Federal tax law unduly limits nonrecognition treatment of triangular mergers, the most important acquisition form used in the United States.¹ The law is internally inconsistent and difficult to understand. The poor state of the rules has real costs to parties involved in corporate acquisitions, who must sacrifice business gains to account for federal tax constraints. This Article explains the genesis of the problem over the one-hundred-year history of our income tax as a byproduct of reciprocal state–federal responsiveness to changes in law and business climate, and offers corrections based on pragmatic and normative views of corporate acquisitions.² It argues that difficulties in the taxation of triangular mergers are a microcosm of larger structural problems in corporate tax law—namely, difficulties created by conflicting conceptualizations of corporate

¹ The heavy use and importance of triangular mergers has long been a featured subject of well-used practitioner manuals. See, e.g., EDWIN L. MILLER, JR., *MERGERS AND ACQUISITIONS: A STEP-BY-STEP LEGAL AND PRACTICAL GUIDE* 84 (2008); ANDREW NUSSBAUM et al., *MERGERS & ACQUISITIONS* 473 (2012).

² When recommending changes to the taxation of triangular corporate acquisitions, we assume continued double taxation of corporate profits and continued recognition of corporations as taxpayers separate from their shareholders.

personhood and Congress's inability to nimbly respond to changes in business.

Subchapter C of the Internal Revenue Code focuses heavily on the *form* of corporate transactions rather than on their *substance*, thus enabling businesses to lodge novel substance within existing forms. This occurs when federal law gives high regard to state law characterizations of business forms, their governance, and their life cycle, or when it leaves terms integral to the operation of the Internal Revenue Code—such as “merger”—open for interpretation by the states. Additionally, ossified features of federal tax law, like the dichotomy between taxation of partnerships and corporations, leave gaps in the statutory structure that create opportunities for state innovation.³ Since Congress cannot respond to such changes nimbly, the Treasury and the IRS are left to employ guidance, regulatory and otherwise, in unanticipated ways.⁴ Over time, and particularly in the area of corporate acquisitions, events such as these have filled federal tax law with complexity and hidden meaning.

Triangular merger provisions perfectly encapsulate the problem. Section 368 of the Internal Revenue Code is the quintessential form-driven tax statute, but Congress cannot predict every new form. Triangular mergers were not included in § 368. Yet, the transaction's many state law benefits, such as the isolation of debt and the preservation of target attributes like state licensures and contracts in place, made it both useful and popular, putting pressure on the existing statute.⁵ The IRS's initial refusal to grant nonrecognition to triangular forms, combined with relevant Supreme Court precedent, eventually led to additional complexity in the law.⁶ As the Treasury and the IRS, through rulings and regulations, responded to taxpayers' attempts to circumvent the prohibition, the law became a thicket.⁷ At the same time, triangular acquisitions became an increasingly large part of acquisition practice. Because it acted *ex post* rather than *ex ante* to address the evolution of corporate practice, Congress's new legislation was path dependent. Rather than write a new law on a clean slate, it added to existing law and analogized new transactions to old ones. As a consequence, when triangular merger legislation was eventually enacted, it was similarly bound to form at the

³ For instance, the creation of the limited liability company (LLC) clearly was unanticipated by the drafters of the 1954 Internal Revenue Code.

⁴ The “check-the-box” regulation is a good example of this. See Treas. Reg. § 301.7701-3 (2012). See generally Heather M. Field, *Checking In on “Check-the-Box,”* 42 LOY. L.A. L. REV. 451 (2009) (analyzing the successes and failures of “check-the-box” regulations); Philip F. Postlewaite, *The Check-the-Box Regulations Turn 10—Will We Survive Their Teen-Age Years?*, 6 J. TAX'N GLOBAL TRANSACTIONS 35, 53 (2006) (describing “check-the-box” regulations as “problem children”).

⁵ For a description of the transactional benefits of triangular mergers, see Part II.A.

⁶ For a description of the development of tax law on triangular mergers, see Part I.

⁷ See Part I.

expense of substance.⁸ As a result, complexity increased and tax neutrality decreased, yet the law remains ill equipped to face new challenges like LLC conversion statutes and mergers with single-member LLCs.⁹ And so the cycle begins again.

Our recommendation for the next one hundred years, then, is that corporate tax statutes be minimalist. Corporate tax statutes should communicate Congress's core normative positions rather than rely on laws and transactional forms that may be altered by outside actors. For corporate acquisitions, this could be accomplished by a lean embodiment of the realization requirement focusing on attributes common to all transactions rather than on unique elements that are perceived to create dividing lines between categories of transactions. Summarized colloquially, the problem with the past one hundred years of § 368 is that for sophisticated taxpayers, lines are made to be blurred.

Part I of this Article describes the history of federal taxation of triangular corporate acquisitions, noting that the tax's current status is a result of both path dependency and Congress's search for consistency. Part II highlights inefficiencies arising under current rules, including a notable lack of tax neutrality among merger forms. Part III proposes revisions made within the constraint of double taxation of corporate profits. Part IV concludes that these solutions are normatively unsatisfying in light of larger structural problems within acquisitions and corporate taxation generally. This Article concludes that, in its next one hundred years, corporate tax law should abandon form-based rules for substance-based standards,¹⁰ allowing the federal government flexibility to address inevitable yet unpredictable changes in both the form and substance of business transactions.

I. VIEWING THE EVOLUTION OF TRIANGULAR REORGANIZATIONS AS A FAILED SEARCH FOR CONSISTENCY

Questions about the taxation of corporate reorganizations are as old as the Internal Revenue Code itself. Do they generate income, and if so, should the income be taxed or should it be granted nonrecognition? Under a nonrecognition regime, an acquiring corporation is not taxed on gain

⁸ See Part I.

⁹ For instance, the law does not address "functional mergers" that occur when a parent corporation acquires a target, converts it to a single-member LLC under state law, or elects to have it treated as a disregarded entity, causing the Treasury to request comments from the tax bar. See Linda Z. Swartz & Richard M. Nugent, *Big A, Little C: Baby Steps Toward Modernizing Reorganizations*, 140 TAX NOTES 233, 233-34 (2013).

¹⁰ See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 561-62 (1992) ("One can think of the choice between rules and standards as involving the extent to which a given aspect of a legal command should be resolved in advance or left to an enforcement authority to consider.").

generated by trading its appreciated stock for stock or assets of the target; the target is not taxed on gain arising from its receipt of assets or stock from the acquirer in exchange for its own stock or assets; and the target's shareholders are not taxed on gain arising from their receipt of acquiring-corporation stock in exchange for their target stock.¹¹

Although nonrecognition of potentially taxable income from a corporate reorganization was not codified until 1918, the Treasury set an early precedent by granting nonrecognition to reincorporations under an innovative state statute that allowed out-of-state corporations to move to Delaware, where corporate and franchise tax rates were lower.¹² Congress's eventual adoption of statutory nonrecognition for corporate reorganizations arrived in 1918.¹³ Enacted against the backdrop of a high individual income tax and a wartime economic boom, the original nonrecognition statute had no agreed-upon purpose but many plausible defenses.¹⁴ Among them was a desire not to tax transactions that occurred only on paper and the hope that nonrecognition would spur business activity.¹⁵ Still others saw it as a compromise between competing ideas of consumption-based and accretion-based taxation.¹⁶ These justifications have remained durable, even though reorganizations are no longer (or never were) purely on paper and despite the existence of conflicting empirical evidence about the effect of nonrecognition on decisions to reorganize.¹⁷

Against this background, we consider the genesis and justification of a particular kind of reorganization: the triangular merger, which involves not only a target and acquiring corporation, but also an acquisition subsidiary. Three traditional acquisitive reorganizations—corporate mergers, stock-for-stock acquisitions, and stock-for-asset acquisitions—may use a

¹¹ See I.R.C. § 1032 (2012) (no gain or loss to acquirer on receipt of property in exchange for stock of acquirer or acquirer's parent); *id.* § 361 (no gain or loss to target corporation in reorganizations); *id.* § 354 (no gain or loss to shareholders of target if target stock is exchanged for acquirer stock or stock of acquirer's parent in reorganization).

¹² Ajay K. Mehrotra, *The Story of the Corporate Reorganization Provisions: From "Purely Paper" to Corporate Welfare*, in *BUSINESS TAX STORIES* 27, 38 (Steven A. Bank & Kirk J. Stark eds., 2005).

¹³ *Id.* at 43.

¹⁴ *Id.* at 52.

¹⁵ *Id.*

¹⁶ See Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 *TUL. L. REV.* 1, 62–63 (2000) (“[T]he original reorganization provision evidences a compromise between the accretion and consumption tax models.”). See also Charlotte Crane, *Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders*, 44 *TAX L. REV.* 113, 142 (1988) (arguing that prior to 1986, the scope of the corporate tax base was indeterminate); Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, in *TAX STORIES: AN IN-DEPTH LOOK AT THE TEN LEADING FEDERAL INCOME TAX CASES* 53, 56–57, 95 (Paul Caron ed., 2003) (“[T]he realization concept in general encourages, at a minimum, a hybrid income/consumption tax because it provides a rationale for the many consumption aspects of the income tax.”).

¹⁷ See Mehrotra, *supra* note 12, at 30 n.14 (citing conflicting studies of the effect of nonrecognition on corporate and shareholder decisionmaking).

subsidiary as the nominal acquirer.¹⁸ More recently, Congress added two more: forward and reverse triangular mergers.¹⁹ These five transactions were legislated ex post to play catch up with the evolution of business transactions and state and foreign laws on liability and corporate management.²⁰ All five accomplish the same goal: the use of parent stock in a corporate acquisition that involves a parent acquirer, a target, and the parent's subsidiary. However, each has its own set of complex criteria.²¹

Normative justifications for the existence of multiple tax categorizations of triangular transactions²² are in short supply. Worse yet, the transactions are complex and overlap with one another, causing one scholar to call them "a Penelope's web."²³ As a prelude to our proposal to collapse these transactions into a single tax-neutral regime that better reflects the reality of modern deal making, the following paragraphs outline the evolution of triangular reorganizations with a focus on path dependency and tax nonneutrality. We begin with the three traditional acquisitive reorganizations—statutory mergers,²⁴ stock-for-stock acquisitions,²⁵ and stock-for-asset acquisitions²⁶—and we conclude with forward and reverse triangular mergers.²⁷

A. *Triangular Drop-Down, B, and C Acquisitions*

1. *Drop-Down Acquisitions.*—The Internal Revenue Code describes three classic forms of tax-preferred acquisitive reorganizations: A, B, and C.²⁸ In a traditional A reorganization, a target corporation merges into the acquiring corporation under state law, leaving former target shareholders in possession of the acquirer's stock.²⁹ The B reorganization allows the acquiring corporation to exchange the target shareholders' stock for the

¹⁸ See I.R.C. § 368(a)(1)(A)–(C) (2012).

¹⁹ *Id.* § 368(a)(2)(D)–(E).

²⁰ See DALE A. OESTERLE, *THE LAW OF MERGERS AND ACQUISITIONS* 33 (4th ed. 2012) (discussing the evolution of transaction forms).

²¹ See § 368(a).

²² See *supra* Parts I.A, I.B.

²³ See Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. PA. L. REV. 1335, 1337 (1985). "An outstanding feature of this statutory scheme is the great amount of overlap existing among these definitions." *Id.* at 1386. As Professor Posin notes, corporate tax law has even been likened to living organisms. *Id.* at 1337 (citing Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 93 (1977)).

²⁴ § 368(a)(1)(A) (describing A reorganizations).

²⁵ *Id.* § 368(a)(1)(B) (describing B reorganizations).

²⁶ *Id.* § 368(a)(1)(C) (describing C reorganizations).

²⁷ *Id.* § 368(a)(2)(D)–(E) (describing A reorganizations, forward triangular mergers, and reverse triangular mergers).

²⁸ *Id.* § 368(a)(1).

²⁹ *Id.* § 368(a)(1)(A); see, e.g., DEL. CODE ANN., tit. 8, § 251 (2001).

acquirer's stock.³⁰ Finally, in a C reorganization, the acquirer uses its stock to obtain "substantially all" of the target corporation's assets.³¹ Each form is subject to a continuity of business enterprise (COBE) requirement, which is satisfied when the acquirer either continues at least one significant line of the target's historic business or uses a significant portion of the target's assets in its business conduct.³² In addition, each must satisfy the continuity of proprietary interest (COI) requirement,³³ which is satisfied when 40% of the compensation received by the target's shareholders consists of acquirer stock.³⁴

Historically, the COBE and COI requirements created a bar to triangular reorganizations, even to transactions where the acquirer transferred the target's assets or stock to a subsidiary.³⁵ Use of a subsidiary as the acquisition vehicle, but parent stock as consideration, meant that target shareholders would have no proprietary interest in the acquirer. This concern over COI led the Supreme Court to hold in *Groman v. Commissioner*³⁶ and *Helvering v. Bashford*³⁷ that the existing statutory regime did not allow an acquisition subsidiary to use parent stock to acquire a target's assets, nor did it allow target assets to pass through the parent into a subsidiary tax free. Congress disagreed and legislatively overruled the Court's decisions. Legislators agreed that tax-preferred status should be given to such transactions even if the transaction used the parent's stock, and even if the parent did not have direct ownership of the acquired corporation following the transaction.³⁸ In short, it intended to

³⁰ I.R.C. § 368(a)(1)(B).

³¹ *Id.* § 368(a)(1)(C).

³² Treas. Reg. § 1.368-1(c)-(d) (2011).

³³ *Id.* § 1.368-1(e).

³⁴ See *id.* § 1.368-1(e)(2)(v) ex. 2; *LeTulle v. Scofield*, 308 U.S. 415, 420-21 (1940) (target shareholders' receipt of long-term bonds classified as equities was insufficient because shareholders had no proprietary interest in acquirer); *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (preferred stock represents a continuing interest); *Helvering v. Minn. Tea Co.*, 296 U.S. 378, 385-86 (1935) (target shareholders' receipt of cash and common stock was sufficient continuing interest); *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462, 470 (1933) (receipt of short-term notes was insufficient because they were not an incident of ownership).

³⁵ See *Helvering v. Bashford*, 302 U.S. 454, 454-55, 458 (1938) (no COI where wholly owned subsidiary of parent acquired target stock); *Groman v. Comm'r*, 302 U.S. 82, 88-90 (1937) (no continuity where parent acquired target assets and dropped them into wholly owned subsidiary); *Standard Realization Co. v. Comm'r*, 10 T.C. 708, 714-15 (1948) (no COBE where assets were transferred to shareholders in liquidating distribution even though shareholders immediately transferred them to a subsidiary because eventual acquirer did not carry on any part of acquired corporation's business and transfer to subsidiary was done for the purpose of selling assets).

³⁶ 302 U.S. at 88-90 (no continuity where parent acquired target assets and dropped them into wholly owned subsidiary).

³⁷ 302 U.S. at 458 (no COI where wholly owned subsidiary of parent acquired target stock).

³⁸ See PHILIP J. LEVINE ET AL., COMMENTS REGARDING TRANSFERS OF ASSETS FOLLOWING PUTATIVE REORGANIZATIONS 6 (2004), <http://www.americanbar.org/content/dam/aba/migrated/tax/pub/policy/2004/040526ct.pdf>.

give corporations more latitude in choosing tax-favored reorganizations.³⁹ Toward that end, Congress enacted new legislation to permit a parent to transfer its newly acquired target assets or stock to a subsidiary,⁴⁰ as occurred in *Groman*.⁴¹ So long as the other requirements of the Code are met, these transactions are afforded nonrecognition treatment.⁴²

2. *Triangular C Reorganizations*.—Congress addressed the *Bashford* case in 1954 by adding triangular C reorganizations to the Code.⁴³ In a C reorganization, the acquirer uses its voting stock to obtain “substantially all” of the target’s assets.⁴⁴ The target typically distributes the stock to its shareholders in dissolution.⁴⁵ Afterward, the former target shareholders own shares of the acquirer, which holds the target’s assets.⁴⁶ In the triangular form of this transaction, the acquirer transfers its own voting stock to a subsidiary, and the subsidiary exchanges its acquirer stock for the target’s assets.⁴⁷ The acquirer must use voting stock to acquire at least 80% of the value of the target’s assets, but any assets in excess of that amount can be purchased for cash, debt, or other consideration.⁴⁸ In addition, the acquirer in a C reorganization must obtain “substantially all” of the target’s assets.⁴⁹ “Substantially all,” a term of art, is not defined by the Code but is instead bounded by court decisions and a regulatory safe harbor.⁵⁰ According to the IRS, this requirement is met if the acquirer obtains 90% of a target’s net assets and 70% of its gross assets.⁵¹ Strangely, this

³⁹ See *id.* at 6–7. For further discussion of this point, see MARTIN D. GINSBURG ET AL., *MERGERS, ACQUISITIONS, AND BUYOUTS* ¶ 701.2.1 (2013).

⁴⁰ See Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19; Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 120.

⁴¹ See S. REP. NO. 88-830, at 82–83 (1964) (explaining the proposed amendment allowing the use of parent stock in acquisition of target stock by subsidiary permitted in B reorganization); S. REP. NO. 83-1622, at 51–52 (1954) (explaining the proposed amendments allowing acquirer in A, B, or C reorganization to drop stock or assets into controlled subsidiary and allowing the use of parent stock in acquisition of assets by subsidiary in C reorganization).

⁴² See S. REP. NO. 83-1622, at 51–52.

⁴³ See STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 83D CONG., *SUMMARY OF H.R. 8300: THE PROPOSED INTERNAL REVENUE CODE OF 1954 AS PASSED BY THE HOUSE OF REPRESENTATIVES 33–34* (Comm. Print 1954). The report, citing *Groman* and *Bashford*, expressly states that the law was proposed to “eliminate[] a formality of existing law.” *Id.*

⁴⁴ I.R.C. § 368(a)(1)(C) (2012).

⁴⁵ See *id.* § 368(a)(2)(G).

⁴⁶ See *id.* § 368(a)(1)(C).

⁴⁷ See *id.*

⁴⁸ See *id.* § 368(a)(2)(B).

⁴⁹ *Id.* § 368(a)(1)(C).

⁵⁰ See, e.g., *Comm’r v. First Nat’l Bank of Altoona, Pa.*, 104 F.2d 865, 870 (3d Cir. 1939) (86% of the net value is substantially all); *Arctic Ice Mach. Co. v. Comm’r*, 23 B.T.A. 1223, 1228 (1931) (68% of the net value is not substantially all); see also Rev. Proc. 77-37, 1977-2 C.B. 568 (1977) (providing regulatory safe harbor).

⁵¹ Rev. Proc. 77-37, 1977-2 C.B. 569.

requirement reappears in the reverse triangular merger,⁵² which is the structural equivalent of the B reorganization.

3. *Triangular B Reorganizations.*—In 1964, Congress added yet another category of nonrecognition acquisition: the triangular B reorganization.⁵³ In B reorganizations, the acquirer exchanges its stock for target stock.⁵⁴ At the conclusion of a traditional B reorganization, the acquirer holds the target as a subsidiary, and the target's shareholders become shareholders of the acquirer.⁵⁵ In a triangular B reorganization, the acquirer transfers voting stock to a subsidiary, and the subsidiary swaps acquirer's stock for target stock.⁵⁶ Afterward, the former target shareholders own shares of the acquirer, which owns shares of the acquisition subsidiary, which owns shares of the target.⁵⁷ Unlike C reorganizations, both the straight and triangular B reorganizations are notable for their strict prohibition on consideration other than voting stock (colloquially referred to as "boot") and their requirement that the acquirer have control of the target at the close of the transaction.⁵⁸ In this context, control is defined as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock" of the target.⁵⁹

In the report accompanying its enactment of triangular B reorganizations, Congress revisited triangular C reorganizations and noted the similarity between triangular C and triangular B reorganizations.⁶⁰ The report went on to say that if COI is satisfied in triangular C reorganizations, it must also be satisfied in triangular B reorganizations since there is little substantive difference between stock and asset acquisitions.⁶¹ With enactment of the triangular B reorganization, Congress essentially sought parity between the stock and asset acquisition methods.⁶²

B. Triangular Mergers

The structural and tax results achieved in triangular B and C reorganizations can be reached through a second set of provisions in the

⁵² See § 368(a)(2)(E).

⁵³ LEVINE ET AL., *supra* note 38, at 6 n.5.

⁵⁴ § 368(a)(1)(B).

⁵⁵ See *id.*

⁵⁶ See *id.*

⁵⁷ See *id.*

⁵⁸ *Id.*

⁵⁹ *Id.* §§ 368(a)(1)(B), (c).

⁶⁰ S. REP. NO. 88-830, at 82-83 (1964).

⁶¹ *Id.* at 83.

⁶² See *id.* The report also claimed allowing Triangular B reorganizations would have only negligible effects on government revenue. *Id.*

Code.⁶³ In the late 1960s and early 1970s, Congress enacted statutes describing forward triangular mergers⁶⁴ and reverse triangular mergers.⁶⁵ Prior to the adoption of these statutes, an acquirer could not use a merger subsidiary to acquire a target corporation in exchange for acquirer stock;⁶⁶ nonetheless, it was still possible to achieve the end result of both the forward and reverse triangular mergers indirectly.⁶⁷ Congress's report on forward triangular mergers pointed out that a parent's acquisition of a target's assets through a merger followed by contribution of those assets to a subsidiary produced the same result for all purposes relevant to taxation.⁶⁸

The report explained enactment of forward triangular mergers by analogizing them to triangular B and C reorganizations⁶⁹ and found no basis for denying the same treatment in the case of statutory mergers.⁷⁰ Congress opined that while forward triangular mergers were not initially provided because lawmakers did not think that companies wanted them,⁷¹ as the country's business climate evolved, "it [was] desired to have an operating company merged into an operating subsidiary in exchange for the stock of the parent holding company."⁷² As a result, Congress found no reason to deny nonrecognition simply because the acquirer did not acquire the target company's assets directly.⁷³

In 1971, Congress enacted reverse triangular mergers.⁷⁴ A Senate report justified their adoption on the same grounds given for forward triangular mergers; namely, their emergence in business and their similarity to preexisting nonrecognition transactions.⁷⁵ The report again focused on consistency. Having created forward triangular mergers, it would be

⁶³ See I.R.C. §§ 368(a)(2)(D) (describing forward triangular mergers), (a)(2)(E) (describing reverse triangular mergers).

⁶⁴ See S. REP. NO. 90-1653, at 3 (1968).

⁶⁵ See S. REP. NO. 91-1533, at 1 (1970).

⁶⁶ *Id.*

⁶⁷ See *id.* at 1-2; S. REP. NO. 90-1653, at 2. For a description of these transactions, see M. Carr Ferguson & Martin D. Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159, 172 (1973).

⁶⁸ S. REP. NO. 90-1653, at 2; see also H.R. REP. NO. 90-1902, at 2 (1968) (explaining how the results of a triangular merger could be obtained indirectly).

⁶⁹ S. REP. NO. 90-1653, at 2-3. These analogies perpetuated questionable distinctions between triangular B and C forms.

⁷⁰ *Id.* at 2.

⁷¹ See *id.*

⁷² *Id.* At the time, state merger and reorganization laws were more relaxed as they "permitted a controlled subsidiary to consummate a triangular statutory merger with another corporation through the use of its parent's stock." 1 BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 12-92 (7th ed. 2000).

⁷³ See S. REP. NO. 90-1653, at 2.

⁷⁴ See Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077; S. REP. NO. 91-1533, at 1-2 (1971).

⁷⁵ See S. REP. NO. 91-1533, at 1-2; see also S. REP. NO. 90-1653, at 1-2 (1968) (explaining that tax-free forward triangular mergers were attainable indirectly through existing provisions of I.R.C. § 360).

nonsensical for Congress to refuse nonrecognition to reverse triangular mergers.⁷⁶ The report noted possible business and legal reasons, aside from tax advantages, for an acquirer to structure a deal as a reverse triangular merger. For example, in contrast to the forward triangular merger, in a reverse triangular merger an acquirer can preserve the target's corporate identity.⁷⁷

Although the Senate acknowledged that acquiring corporations could achieve this same outcome through B reorganizations,⁷⁸ the report deflected the argument that B reorganizations were sufficient. Instead, the report noted that in order to qualify as a B reorganization, "it is necessary that the acquisition be *solely* for voting stock and that no stock be acquired for cash or other consideration."⁷⁹ In the same vein, the report mentioned taxpayer concerns about the use of old and cold stock in a B reorganization. In these situations, an acquirer may already hold stock of the unrelated corporation, having purchased it earlier without reference to any future reorganization. In such cases, taxpayers worried that the IRS might argue that nonvoting stock consideration had been used in the purported B reorganization.⁸⁰ Rather than amend the B reorganization rules to alleviate these concerns, Congress granted nonrecognition treatment to reverse triangular mergers. Legislative history indicates that Congress enacted reverse triangular mergers because it did not see any reason to allow triangular mergers in one direction and not the other, nor did it see any reason to limit the consideration paid to target shareholders solely to stock. Again, Congress seems to have been in search of consistent tax rules for similar transactions, although strangely, it chose to pursue this goal through the addition of new provisions, rather than the harmonization of existing ones.

If we accept consistency as the motivation behind the legislature's various amendments to the law governing acquisitive reorganizations, the technical requirements for forward and reverse triangular mergers are particularly bizarre. Because they are mergers, both transactions must meet the requirements applicable to A reorganizations.⁸¹ In addition, each has its own peculiar description.⁸²

In a forward triangular merger, the acquirer transfers stock to a subsidiary. The subsidiary uses that stock to acquire "substantially all" of

⁷⁶ S. REP. NO. 91-1533, at 2.

⁷⁷ I.R.C. § 368(a)(2)(E) (2012). For instance, the target may have important licensures or contracts in place that would not survive in a forward merger. OESTERLE, *supra* note 20, at 172–73.

⁷⁸ S. REP. NO. 91-1533, at 2.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ See §§ 368(a)(2)(D) (describing forward triangular mergers), 368(a)(2)(E) (describing reverse triangular mergers).

⁸² *Id.* §§ 368(a)(2)(D)–(E).

the assets of the target in a merger transaction.⁸³ Congress's adoption of the "substantially all" test is not surprising here. The test usually applies to C reorganizations, and the functional result of a forward triangular merger is the same as that of a triangular C reorganization. When the transaction is complete, the target's shareholders own stock of the acquirer, which holds stock of a subsidiary in which "substantially all" of the target's assets are lodged. Unlike C reorganizations, however, forward triangular mergers do not require the acquirer to use voting stock.⁸⁴

In a reverse triangular merger, a subsidiary of the acquirer merges into the target.⁸⁵ The acquirer's subsidiary stock is extinguished and replaced by target stock in the merger. Following the merger, the target must hold "substantially all" of its assets, as well as "substantially all" of the assets of the merged subsidiary.⁸⁶ The target stock is then converted to voting stock of the acquirer.⁸⁷ After the transaction, the acquirer must have shares representing statutory control over the target.⁸⁸

The structural result of the reverse triangular merger is identical to the B reorganization.⁸⁹ At the conclusion of the deal, former target shareholders own shares of the acquirer, which owns shares of the target. Unlike the B reorganization, however, the reverse triangular merger is subject not only to the control requirement, but also to a requirement that the target retain "substantially all" of its historical assets, as well as "substantially all" of the merged subsidiary's assets.⁹⁰ And there is a second important difference. In a B reorganization, even a small amount of nonstock compensation paid to target's shareholders is fatal to nonrecognition, but a reverse triangular merger qualifies for favorable treatment under the permissive A reorganization rules, which allow a substantial amount of such compensation.⁹¹ This discrepancy does exactly what Congress sought to avoid with its many amendments to the reorganization provisions: it

⁸³ *Id.* § 368(a)(2)(D).

⁸⁴ *Id.*

⁸⁵ *See id.* § 368(a)(2)(E).

⁸⁶ *Id.* § 368(a)(2)(E)(i).

⁸⁷ *See id.* § 368(a)(2)(E)(ii).

⁸⁸ *Id.* Once again, control in this context means "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock" of the target. *See id.* § 368(c).

⁸⁹ This assumes, of course, that all B shareholders agree to tender their shares in the B reorganization. The problem of "hold-out" B shareholders in a stock acquisition is a significant planning disadvantage.

⁹⁰ Compare § 368(a)(1)(B), with *id.* § (a)(2)(E).

⁹¹ Compare I.R.C. § 368(a)(1)(B), with *id.* § (a)(2)(E). *See also* BITTKER & EUSTICE, *supra* note 72, at 12-93 ("[A] limited amount of other consideration . . . will not destroy reorganization status under this provision, whereas it would be fatal if the transaction had to meet the requirements for a Type B reorganization.").

allows (or forces) similarly situated taxpayers to recognize different tax results arising from similar transactions.

Congress's road to triangular mergers, while paved with good intentions, failed to provide consistency, reduce complexity, or focus on substance over form.⁹² Professor Ginsburg described the law as "an anthology of some of the most difficult interpretative problems" of reorganization transactions, creating "an extraordinary fabric of interdependent qualifications that defies simple application or administration."⁹³ Professors Bittker and Eustice wrote, "[T]he substantive differences between these variations on the triangular-merger technique are slight, the surviving corporation's identity being the principal technical distinction, so that form continues to play a dominant role in this corner of the reorganization area."⁹⁴ Congress's elevation of form over substance is bizarre, particularly since all acquisitive reorganizations share defining characteristics outside of their form, and since it has long been the IRS's policy to penalize taxpayers who elevate form over substance in other areas.⁹⁵

II. OVERLAP AND INCONSISTENCY CREATE ARTIFICIAL HURDLES IN ACQUISITION PLANNING

A. *Advantages of Triangular Mergers*

Before recommending liberalization of the taxation of triangular mergers, let us establish that these transactions are more than mere tax gimmicks. The first substantive advantage of triangular mergers is protection of the acquirer's assets from the target's creditors.⁹⁶ A second advantage is that the approval of a mere majority of the target shareholders will permit the acquirer to gain total control of the target.⁹⁷ Third,

⁹² As Professors Bittker and Eustice have noted, "There is a similar conflict of jurisdiction within the reorganization provisions themselves, since, to take but one example, a statutory merger may be indistinguishable in results from an exchange by one corporation of its voting stock for all of the assets of another corporation; however, different statutory rules are prescribed for these functionally equivalent types of reorganization." BITTKER & EUSTICE, *supra* note 72, at 12-13.

⁹³ Ferguson & Ginsburg, *supra* note 67, at 185.

⁹⁴ BITTKER & EUSTICE, *supra* note 72, at 12-53. In particular, the forward triangular merger and the triangular B reorganization, and the reverse triangular merger and the triangular C reorganization produce identical structural results. 2 BITTKER & EUSTICE, *supra* note 72, at ¶ 803.[5], 61 (describing overlap between reverse triangular merger and B reorganization).

⁹⁵ See Frank Lyon Co. v. United States, 435 U.S. 561, 572-73 (1978); Gregory v. Helvering, 293 U.S. 465, 470 (1935); David E. Watson, P.C. v. United States, 668 F.3d 1008, 1017-18 (8th Cir. 2012); Altria Grp., Inc. v. United States, 658 F.3d 276, 284 (2d Cir. 2011); BB&T Corp. v. United States, 523 F.3d 461, 477 (4th Cir. 2008); True v. United States, 190 F.3d 1165, 1173-74 (10th Cir. 1999).

⁹⁶ OESTERLE, *supra* note 20, at 64-65. See also United States v. BestFoods, 524 U.S. 51 (1998) (discussing parent liability for subsidiary environmental liabilities).

⁹⁷ See, e.g., DEL. CODE ANN., tit. 8, § 251 (2001).

ownership of the target's assets and liabilities "vest" in the acquisition subsidiary "as a matter of law."⁹⁸ Thus a party to a "personal" contract with the target or in a contract subject to an express anti-assignment clause may not avoid the contract even if the target does not survive the merger.⁹⁹ There is also no need to execute new title for registered assets of the acquired company: real estate deeds, leases, title documents for vehicles, and, in many cases, government permits and licenses. Finally, the fourth advantage, available in some deals, is absence of parent shareholder voting and appraisal rights.¹⁰⁰ These planning advantages are substantively important to business and justify liberalization of tax rules applicable to triangular mergers.

B. Triangular Merger Rules Are Complex and Lack Tax Neutrality

The awkward evolution of the tax rules on triangular mergers—now the most popular deal structure—has led them to unduly discriminate between triangular mergers and direct mergers, and between forward and reverse triangular mergers. One important goal of nonrecognition in the reorganization context should be tax neutrality. For triangular mergers, this means that tax considerations should not affect the choice between straight and triangular forms or between forward and reverse forms of merger. When the Code treats these forms differently, disparate treatment should reflect normatively relevant differences among the forms.

The merger rules fail tax neutrality in multiple ways. First, straight A reorganizations are not subject to the substantially-all test, but triangular mergers are. As a consequence, an A reorganization may be preceded by a spinoff or the target's redemption of shares, but the same measures are extremely difficult in the forward and reverse transactions despite all three transactions being mergers under state law.¹⁰¹ Although one might justify use of the test in the forward triangular merger because the resulting structure is identical to that produced by a triangular C reorganization (to which the substantially-all test would regularly apply), this logic cannot extend to the reverse triangular merger, which produces a structure identical to a B reorganization. Furthermore, if one looks only at the end result of the transaction rather than the procedure used to get there, the straight A and C reorganizations are identical in many cases, since the acquirer obtains assets of the target, while target shareholders receive stock of the acquirer. Consequently, if Congress were creating law by analogy to existing forms, the substantially-all test should apply to both the straight A

⁹⁸ See, e.g., *id.* §§ 261, 269.

⁹⁹ See, e.g., *Imperial Enters. v. Fireman Fund Ins. Co.*, 535 F.2d 287, 292-93 (5th Cir. 1976) (holding that a company's insurance policy remained valid after a merger).

¹⁰⁰ E.g., *Terry v. Penn Cent. Corp.*, 668 F.2d 188, 194 (3d Cir. 1981) (holding that parent corporation's shareholders lacked dissent and appraisal rights in subsidiary's merger).

¹⁰¹ See GINSBURG ET AL., *supra* note 39, at § 801.2.

and the straight C reorganizations, or to neither.¹⁰² In either case, it makes little sense to apply it in the triangular merger context but not in the context of the straight A reorganization.

A second example of nonneutrality comes from the application of the control test to reverse triangular mergers but not to forward triangular mergers. The statutory definition of the reverse triangular merger requires the acquisition subsidiary to acquire “control” of the target in exchange for parent voting stock or its own voting stock.¹⁰³ This limits payments of cash or cash equivalents, debt instruments, and other consideration; they cannot be used to acquire more than 20% of the target stock. Moreover, the acquirer must exchange its voting stock for 80% of each class of nonvoting stock of the target.¹⁰⁴ The same limitations do not apply to the forward triangular merger or to the straight A reorganization. The consideration used in those forms is limited only by the much looser COI requirement.¹⁰⁵

Although this disparate treatment may stem from the reverse triangular merger’s similarity to a B reorganization, which employs a similar control test and produces the same structure, the resemblance is incomplete. If Congress meant to treat the reverse triangular merger in the same manner as a B reorganization, the regulations should not require acquirers to gain all 80% of the target’s vote and value in the merger, but the B reorganization allows for creeping acquisitions,¹⁰⁶ whereas the reverse triangular merger does not.¹⁰⁷ We can think of no normative reason why preownership of target stock would be permitted in one context and not the other.

A third disparity between forward and reverse triangular mergers relates to the parent’s basis in the subsidiary stock at the conclusion of the deal. Planners using a reverse triangular merger have an advantage; they can elect between two rules for the parent’s basis in the target stock if the transaction can also qualify as a B reorganization or a § 351 contribution.¹⁰⁸ The parent may either elect to treat as its basis the basis of its stock in the

¹⁰² If Congress is truly concerned with the acquirer’s level of asset acquisition, perhaps the requirement should apply to both A and C reorganizations. Including it will prevent parties to acquisitions from seeking nonrecognition status for mergers that are actually divisive, such as the one described in Rev. Rul. 2000-5. See Rev. Rul. 2000-5, 2000-1 C.B. 436 (a transaction that qualified as a merger under state statute but which divided target assets between two acquirers was not a merger for federal purposes).

¹⁰³ I.R.C. § 368(a)(2)(E) (2012).

¹⁰⁴ *Id.* § 368(c).

¹⁰⁵ *Id.* §§ 368(a)(1)(A), (a)(2)(D).

¹⁰⁶ For a discussion of creeping B reorganizations, see BITTKER & EUSTICE, *supra* note 72, at 7-24.

¹⁰⁷ See Treas. Reg. § 1.368-2(j)(3)(i) (as amended in 2010). In some cases, though, a creeping reverse triangular reorganization will be tested as a forced B reorganization and may receive nonrecognition treatment if it meets the definition of § 368(a)(1)(B). See GINSBURG ET AL., *supra* note 39, at § 803.1.

¹⁰⁸ See Treas. Reg. § 1.358-6(c)(2)(C)(ii) (as amended in 2008).

acquisition subsidiary, increased as though the parent had acquired the target's assets directly and contributed them to the subsidiary (standard treatment in an asset acquisition), or it may instead choose as its basis the basis of its stock in the acquisition subsidiary increased by the target shareholders' bases in the converted shares.¹⁰⁹ This election is limited in scope and often outweighed by the restrictions on use of consideration other than voting stock. Nonetheless, it represents yet another discrepancy between the two triangular merger forms.¹¹⁰

A fourth example of nonneutrality stems from the use of LLCs in corporate acquisition transactions. Section 368's acquisition provisions are form driven and confined to transactions between corporations. The real world, however, is not similarly confined. A number of states now permit mergers between corporations and noncorporate forms.¹¹¹ These developments in state law, combined with the Treasury's decision to disregard the existence of single-member LLCs that make no check-the-box election,¹¹² have opened up a new form of triangular transaction: merger with a disregarded entity.¹¹³ In these transactions, the acquirer forms a single-member LLC (for tax purposes, this entity is disregarded as merely an extension of the acquirer),¹¹⁴ and the target merges into the disregarded entity. For state purposes, the disregarded entity is a separate person, and the acquirer is protected from liabilities of the target, just as in other triangular transactions. For federal purposes, the disregarded entity is invisible, and the target is merged directly into the acquirer.¹¹⁵ Under § 368, the transaction is a straight A reorganization and not subject to additional requirements applicable to forward and reverse triangular mergers.¹¹⁶ The ability to conduct a triangular merger without resort to the triangular merger rules in these cases further highlights the way in which § 368's dependency on form reduces tax neutrality and increases complexity.¹¹⁷

By distilling the history of tax treatment of reorganizations to its essence, we find rules that have struggled to keep up with acquisition

¹⁰⁹ *Id.*

¹¹⁰ Although, from a normative and theoretical standpoint, granting such an election in the context of a forward triangular merger raises fundamental questions about respect for corporate personhood, from the practical perspective of a transactional attorney, there may be no obvious reason for granting the election in one context and not the other.

¹¹¹ See OESTERLE, *supra* note 20, ch. 2.

¹¹² See Treas. Reg. § 301.7701-2 (2012).

¹¹³ See Treas. Reg. § 1.368-2(b)(1) (as amended in 2010); I.R.S. Priv. Ltr. Rul. 2002-36-005 (Sept. 6, 2002).

¹¹⁴ Treas. Reg. § 1.368-2(b)(1) (as amended in 2010).

¹¹⁵ I.R.S. Priv. Ltr. Rul. 2002-36-005.

¹¹⁶ Treas. Reg. § 1.368-2(b)(1) ex. 2.

¹¹⁷ The disregarded entity merger rules themselves are plagued by nonneutrality. According to the regulations, the transaction can proceed only in one direction: a merger of target into the acquirer's disregarded entity. See Treas. Reg. § 1.368-2(b)(1)(iii) ex. 6.

practice over the years. Tax law irrationally penalizes reverse triangular mergers by significantly limiting the forms of consideration that an acquirer can offer the target's shareholders; however, it does not similarly penalize the forward triangular merger. And the penalty for using any type of triangular merger rather than a straight merger—application of the substantially-all test—not only creates nonneutrality among merger forms but is also redundant in light of the IRS's interpretation of "merger," which prohibits nonrecognition for divisive transactions.¹¹⁸ In short, federal tax law has failed to keep up with the evolution of state corporate law on acquisitions.

III. A PRAGMATIC RESPONSE

The problem created by complexity and overlap within the nonrecognition laws is not only costly but also seemingly intractable. For this reason, we suggest two responses: one pragmatic and one that raises normative questions about the nonrecognition scheme generally. The goal of our pragmatic proposal is not to address the theoretical underpinnings of current tax law. Rather, we propose changes that are explicitly pro-deal in that they resolve all classification conflicts in favor of tax-preferred treatment for the deal. In essence, the approach favors stock-swap triangular deals under the theory that cash is dear and that immediate tax recognition in such deals would stop many at the margin. Here, we assume a properly functioning capital market where corporate acquisitions will not occur unless they leave most interested parties in a better position than they would have been absent contracting. We also assume that removing barriers to corporate acquisitions will be Kaldor–Hicks efficient and therefore social welfare increasing.¹¹⁹ We recognize that these assumptions may not hold true for any particular corporate acquisition, but we assume that they are true when applied to such acquisitions in the aggregate.

A. Important Predecessor Proposals

We are not the first to recognize that the current state of reorganization law is suboptimal, and the failure of prior attempts to improve this area of the law demonstrate the difficulty of the task. In the mid-1980s, Congress attempted a substantial overhaul of the federal taxation of corporate reorganizations. A senate report observed that the "law" consists of a series of rules, some statutory and others of judicial origin, which, when taken together, lack consistency, are unnecessarily complex, and are often

¹¹⁸ See Rev. Rul. 2000-5, 2000-1 C.B. 436 (a transaction that qualified as a merger under state statute but which divided target assets between two acquirers was not a merger for federal purposes).

¹¹⁹ A transaction is Kaldor–Hicks efficient if the gains of those who are made better off could be used to fully compensate those who are made worse off. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 17–18 (8th ed. 2011).

subject to manipulation."¹²⁰ The report could find no policy justification for the different consideration (cash or stock) requirements between A, B, and C reorganizations.¹²¹ Additionally, the complexity of the regime and the lack of clarity in important terms, such as "substantially all," concerned Congress.¹²² Congress also raised concerns that the law incentivized reorganizations for trivial noneconomic reasons and led to corporate manipulation.¹²³ As a result, Congress wanted to eliminate artificial distinctions and disparate rules in the taxation of acquisitive reorganizations.¹²⁴

Congress proposed substantial revisions to the reorganization rules. In 1983, the Staff of the Senate Committee on Finance issued a preliminary report that identified problems and proposed changes,¹²⁵ such as giving corporations more latitude in nonrecognition transactions.¹²⁶ Additionally, the initial report proposed repealing "elaborate definitional rules" in § 368 while providing relief from related judicial doctrines and proposed a reclassification of corporate reorganizations.¹²⁷

In 1985, the Staff of the Senate Committee on Finance issued a final report, which closely tracked the 1983 report, along with a proposed bill. The report noted that the "bill consolidates, simplifies, and makes uniform the rules classifying corporate mergers and acquisitions, whether treated under current law as a 'reorganization', a liquidating sale under section 337 of the Code, or a section 338 stock acquisition."¹²⁸ The most sweeping change proposed by the committee was the repeal of § 368. The committee sought to replace corporate mergers and reorganizations under § 368 with "qualified acquisitions," which were either a transaction or series of transactions where one corporation acquires stock representing control over another or a merger or consolidation or any other transaction where at least 70% of the gross fair market value of assets and 90% of the net fair market value of assets were transferred.¹²⁹ The proposal addressed many of the inconsistencies described above and gave corporations structural flexibility in tax-preferred reorganizations. While hailed by commentators, it never

¹²⁰ STAFF OF S. COMM. ON FIN., 99TH CONG., THE SUBCHAPTER C REVISION ACT OF 1985, at 37 (Comm. Print 1985).

¹²¹ *Id.* at 38.

¹²² *Id.* at 38, 39.

¹²³ *See id.* at 38.

¹²⁴ *See id.* at 39.

¹²⁵ STAFF OF S. COMM. ON FIN., 98TH CONG., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 1-2, 55-81 (Comm. Print 1983).

¹²⁶ *Id.*

¹²⁷ *Id.* at 55.

¹²⁸ STAFF OF S. COMM. ON FIN., 99TH CONG., *supra* note 120, at 50.

¹²⁹ *Id.*

left the committee.¹³⁰ Similarly, an ALI proposal from the early 1980s that would have made nonrecognition elective did not gain traction in the legislature.¹³¹

I. A Modest Proposal.—Prior attempts at sweeping change have met with difficulty in the political process, so perhaps a more modest proposal is needed. Because most nonrecognition acquisitions are conducted as triangular mergers, a proposal need not amend the entirety of the nonrecognition scheme in order to effectively neutralize negative tax effects on popular forms of stock swap deals. Thus, our initial proposal does not advocate for repeal of § 368. Rather, it urges Congress to decouple tax treatment of shareholders from that of the target corporation and to move away from continuity of interest and continuity of business enterprise tests toward a bare control test in triangular mergers. We first address the treatment of shareholders under § 354 and § 356. We then address application of bare control test to the target.

B. Decoupling Shareholder Nonrecognition from Target Nonrecognition

Under current law, shareholders of a target corporation are entitled to nonrecognition treatment only if the target is party to a reorganization.¹³² The statutory definitions of reorganizations, however, have become increasingly arbitrary due to transactional ingenuity, allowing taxpayers a de facto election of either reorganization or recognition treatment.¹³³ For this reason, and because modern law views the corporation as a separate taxpayer, we argue that there is no normatively significant difference for

¹³⁰ See BITTKER & EUSTICE, *supra* note 72, at 12-15, 12-16 (praising proposal's grant of nonrecognition treatment regardless of the type of consideration used to pay for the deal while noting that the proposal "vanished into the ether"). Cf. Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. PA. L. REV. 1335, 1395-405 (1985) (noting that the committee's proposal would leave a substantial amount of complexity in place, and among other problems, it would be susceptible to creative planning by taxpayers).

¹³¹ See AM. LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 24-50 (1982) (proposal A1 would allow taxpayers to elect to treat acquisitions as either cost-basis acquisitions or carry-over basis acquisitions). For two ends of the spectrum of scholarly debate, see Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 BYU L. REV. 1, 3-4 (proposing complete repeal of Section 368), and Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 183 (1989) (proposing mandatory nonrecognition for transfers of "an entire business activity").

¹³² See I.R.C. § 354 (2012).

¹³³ COI and COBE requirements apply only to the merged corporation. Their application to the target can be easily avoided by merging the acquirer into the target or through use of Section 351. For examples of these transactions, see GINSBURG ET AL., *supra* note 39, at §§ 610.8, 610.9, 611.1. In this vein, Professor Coven has argued that § 368's rigid definitions create transactional electivity. See Coven, *supra* note 131, at 156 & n.36.

tax purposes between stock-for-stock or securities-for-securities swaps either within or without a reorganization. Both may be conceptualized as like-kind exchanges or involuntary conversions.

The appropriate treatment of shareholders who exchange stock of a target for stock of an acquirer depends upon the proper conceptualization of stock. This, in turn, is inseparable from one's conceptualization of the corporation. In other words, how the government should tax exchanges of stock depends on whether stock is merely a property interest (an entity view), or whether stock denotes participation in a collective endeavor, representing both an ownership interest in, and the right to make decisions about, the management of an underlying corporation's property and opportunities (an aggregate view).¹³⁴

When a shareholder's ability to influence corporate decisionmaking is negligible (let us call this the "ineffectual shareholder"), the entity view of the corporation is appropriate. The ineffectual shareholder's ownership of stock represents investment in a piece of property, the value of which may appreciate, but it does not connote inclusion in a collective endeavor. For the ineffectual shareholder, stock is merely property, so it stands to reason that nondistribution actions taken by the corporation should have no tax consequences to the shareholder. In contrast, if a shareholder has the ability to influence corporate decisionmaking (let us call this the "influential shareholder"), the aggregate view of corporations may be more appropriate. The influential shareholder exerts influence over property and opportunities of the corporation, either alone or as part of an influential group. Because an influential shareholder's stock connotes not only property ownership but also participation at the corporate level, it may be appropriate to attribute actions of the corporation to the shareholder for tax purposes.¹³⁵

The dichotomy between the ineffectual and influential shareholders is somewhat artificial. State law enables corporations to create a spectrum of shareholder rights and responsibilities, and these two groups represent both ends of that spectrum. We need not draw lines of demarcation between them, though, because nonrecognition treatment is justifiable at either end by analogy to nonrecognition transactions that are not reorganizations: involuntary conversions and like-kind exchanges. When a shareholder has no practical influence over a merger decision or votes against it, the conversion of target shares into acquirer shares is not a voluntary transaction. Rather, it is an involuntary conversion that happens purely by operation of law, regardless of the ineffectual shareholder's consent or lack

¹³⁴ For further discussion of aggregate versus entity views of the corporation, see DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 10–11 (2009).

¹³⁵ We readily acknowledge that, if taken to its logical conclusion, this assertion represents an endorsement of corporate integration in many instances.

thereof.¹³⁶ Like a person receiving nonrecognition treatment after losing property to a natural disaster or eminent domain,¹³⁷ the ineffectual shareholder did not intentionally alienate her target shares and acquire replacements. As a consequence, it would make little sense to impose a tax on her receipt of replacement property. In contrast, an influential shareholder may affect the decision to merge, and so, the aggregate view of corporations supports treatment of the exchange of shares as a form of like-kind exchange, similar to those described by § 1031.¹³⁸ The influential shareholder has willingly exchanged one capital venture for another, similar capital venture. Just as in like-kind exchange, it may make little sense to tax the influential shareholder on the receipt of replacement shares, as she has not severed any profit from her capital.¹³⁹

The analogies are not misplaced. Section 354, which grants nonrecognition to target shareholders who receive acquirer stock in § 368 transactions,¹⁴⁰ produces a result that mirrors tax treatment of involuntary conversions and like-kind exchanges. A shareholder's gain is taxed only to the extent that she receives cash or other property, and she takes a transferred basis in her replacement shares.¹⁴¹ Favorable treatment is limited, though, by § 354's cross-reference to § 368's reorganization definitions.¹⁴²

We question the necessity of this limitation. Because the conversion of target shares into acquirer shares can happen over the objection of the ineffectual shareholder, it is difficult to attach normative significance to the categorization of the underlying transaction as being either a nonrecognition transaction or a taxable one. An ineffectual shareholder who receives acquirer shares in exchange for target shares is similarly situated in either a taxable or a nontaxable merger. For this reason, we argue that § 354 should be extended to cover ineffectual shareholders whose target shares are exchanged for shares of an acquirer even in a taxable merger.

A similar rationale may apply to influential shareholders, who may be viewed as collaborators in the corporate enterprise. If they vote against the merger but lose, their stock is involuntarily converted. If they vote for the

¹³⁶ For the tax treatment of involuntary conversions, see I.R.C. § 1033. Contract law may provide an argument that the purchase of shares represents advance consent to the transaction since provisions of the charter and bylaws are binding on the shareholder. Here, we focus on actual consent to the specific transaction.

¹³⁷ *Id.*

¹³⁸ *See id.* § 1031.

¹³⁹ We are willfully ignoring the thorny realization questions that might be raised by borrowing against the increased value of capital, since they are discussed elsewhere and are tangential to our project.

¹⁴⁰ *See* § 354.

¹⁴¹ *Id.* § 356.

¹⁴² *See id.* § 354(a)(1) (nonrecognition provided to "a party to the reorganization").

merger, they have volunteered to exchange one capital investment for another of related character. Unless they receive cash or other property, influential shareholders have not severed any profit from their capital investment, just as in a like-kind exchange. And if they *have* severed profit from their capital through the receipt of cash or other boot, realization and recognition are required. This reasoning applies regardless of whether the merger is taxable or qualifies as a reorganization, yet nonrecognition treatment is currently only afforded in the context of a reorganization. As a result, § 354's reliance on § 368's reorganization definitions produces disparate treatment for similarly situated shareholders. This discrepancy may be cured by extending nonrecognition treatment to all shareholders who exchange target stock for acquirer stock in any merger, regardless of its compliance with § 368.

In sum, the consequences of the merger, rather than its form, should trigger nonrecognition treatment of target shareholders' gain upon receipt of acquirer stock. Those shareholders continue to hold a residual claim in the productivity of the assets transferred, albeit diluted by the other assets of the acquirer. If a shareholder has consented to the merger, the continuation of a shareholder's investment establishes a serviceable analogy to like-kind exchanges. If a shareholder has not consented to the merger, the forced conversion of the shareholder's target stock into acquirer stock is analogous to an involuntary conversion. In either case, it makes little sense to either grant or deny nonrecognition treatment on the basis of whether the target will, itself, be taxed in the merger. The nontax result for the shareholder will be the same, regardless of whether the target pays any tax in the deal.

C. *Nonrecognition of Target Gain and Loss*

There are a variety of ways in which the triangular merger statutes might be amended with respect to nonrecognition by the target. Here we propose an approach meant to facilitate transactions by loosening the rules and increasing tax neutrality between merger forms.

In most triangular mergers, the target's assets vest in the acquisition subsidiary, and the consideration, whether stock or boot, is paid directly to the target shareholders.¹⁴³ In most cases, the target recognizes neither gain nor loss on the exchange.¹⁴⁴ Similarly, neither the parent nor the acquisition subsidiary recognizes gain or loss on the exchange.¹⁴⁵ The acquisition subsidiary normally takes a carryover basis in the target assets equal to the

¹⁴³ A target that receives and retains consideration other than stock will be taxed on gain to the extent of the retained consideration. *See id.* § 361(b)(1). For that reason, a target will generally prefer distribution over retention.

¹⁴⁴ *See id.* § 361.

¹⁴⁵ *See id.* § 1032.

target's basis.¹⁴⁶ The parent's basis in the subsidiary stock is stepped up by the net inside basis (basis less liabilities assumed) of the target's assets.¹⁴⁷ In reverse triangular mergers that also qualify as a B reorganization or a § 351 contribution, however, the parent may opt to step up the basis in its subsidiary shares by the amount of the target shareholders' basis in their target stock.¹⁴⁸ If one believes that continued existence of the target in either of those transactions has no normative implications for the basis determination, this election should be available in forward triangular mergers as well.

Modifications suggested here also would affect nonrecognition by the target and the target's subsidiary. To create parity of nonrecognition among the various mergers permitted in § 368, Congress should eliminate the requirement that the surviving subsidiary hold "substantially all" of the assets of the target. Furthermore, it should eliminate the enhanced control test (the 80% rule) applicable to reverse triangular mergers.¹⁴⁹ The "substantially all" requirement is redundant in light of the IRS's interpretation of "merger," which prohibits nonrecognition in divisive transactions.¹⁵⁰ Furthermore, the control test as applied to reverse triangular mergers creates nonneutrality among merger forms and imposes a harsh restriction on the use of nonvoting stock as consideration.¹⁵¹

There are also a number of rules that apply to both forward and reverse triangular mergers that seem odd at best. First, the COI test has morphed into a consideration test and is duplicative of § 368's consideration requirements for triangular mergers. Second, the IRS has held that a target's redemption of its own stock before the closing does not count toward the "control test" but does count for the "substantially-all" test, a position which unnecessarily increases the law's complexity.¹⁵² Finally,

¹⁴⁶ See *id.* § 362(b).

¹⁴⁷ See Treas. Reg. § 1.358-6(c)(2)(i) (2012).

¹⁴⁸ See *id.* § 1.358-6(c)(2)(ii).

¹⁴⁹ See *supra* notes 103–04 and accompanying text.

¹⁵⁰ See Rev. Rul. 2000-5, 2000-1 C.B. 436 (a transaction that qualified as a merger under state statute but which divided target assets between two acquirers was not a merger for federal tax purposes). Furthermore, the "substantially all of the assets" test has been stripped of much of its original meaning. Sale of fifty percent of the assets of the target, either before or after the reorganization, does not violate the test so long as the cash remains within the structure. See Rev. Rul. 2001-25, 2001-1 C.B. 1291; Rev. Rul. 88-48, 1988-1 C.B. 117. Since the target is taxed on such sales, there is no tax advantage from a part sale, part merger acquisition. Even if the target distributes this cash before or after the merger, the distribution is taxable, so the IRS may eventually loosen the cash retention requirement.

¹⁵¹ Although the control test also applies in the context of B reorganizations, acquirers may gain control or maintain it using old and cold stock in those transactions, whereas the use of old and cold stock is not permitted in a reverse triangular merger. See I.R.C. §§ 368(a)(1)(B), (a)(2)(E), (c) (2012).

¹⁵² See Treas. Reg. § 1.368-2(j)(6) exs. 2 & 3 (T shares redeemed using cash of T are not counted for purposes of the control test); Rev. Proc. 77-37, 1977-2 C.B. 568 § 3.01 (redemptions, extraordinary

there is considerable overlap among triangular mergers and stock or asset acquisitions (B and C reorganizations), and there are cases in which forward or reverse triangular mergers that do not qualify under their specific subsections in § 368 may still qualify as B or C reorganizations.¹⁵³ Triangular mergers may also overlap with acquisitions conducted through § 351.¹⁵⁴

Under the approach in this subsection—that of seeking minimal damage to the basic reorganization structure of the Code—the essence of nonrecognition at the target level in current law rests on two distinctions: the distinction between a deal that is an acquisition and one that is not (a naked purchase and sale of capital), and the distinction between a stock swap and a cash acquisition. Cash acquisitions, under traditional principles, are not tax-preferred reorganizations. Accordingly, nonrecognition statutes for triangular mergers should quickly and unequivocally distinguish stock swaps from cash deals and acquisitions from nonacquisitions.¹⁵⁵

A pared-back version of the control test for both forward and reverse triangular mergers would do both jobs well and cleanly.¹⁵⁶ Moreover, the control test should be the same for both forward and reverse triangular mergers. If, once the deal closes, the parent has exchanged its stock for some sensible measure of legal control of the target, the parent has purchased control in a stock swap. Anything more could be acquired using other forms of consideration. There is no need for the fading COI or COBE tests or for the “substantially all” test given the fact that shareholders are taxed currently on the receipt of nonstock consideration in a nonrecognition transaction and given the IRS’s refusal to recognize divisive mergers under state law as mergers for federal tax purposes.¹⁵⁷

In corporate law, just as in tax, there are multiple definitions of control. In the reorganization context, one could argue that a legal control test, resting on the percentage of stock necessary under state law to elect a

dividends, and payments to dissenters are considered when determining whether substantially all of the assets have been transferred).

¹⁵³ See, e.g., Rev. Rul. 2008-25, 2008-1 C.B. 986 (where the target in a reverse triangular merger liquidates into the acquiring parent, the transaction will be tested as a C reorganization).

¹⁵⁴ For instance, the “horizontal double-dummy technique” may provide nonrecognition treatment in some instances where the requirements of Section 368 would not be satisfied. See GINSBURG ET AL., *supra* note 39, at § 904.

¹⁵⁵ The ALI has recommended that reorganization treatment be expressly elective. We note that our use of a bright-line test would create a transactional elective for most taxpayers. See AM. LAW INST., *supra* note 131. Nonetheless, the notion of an express election is intriguing and could apply to both approaches we suggest in this Article. We take no position on its merits here, as our focus is clarifying nonrecognition rules applicable to triangular mergers.

¹⁵⁶ See *supra* note 103 and accompanying text.

¹⁵⁷ See I.R.C. § 354 (2012) (nonrecognition provided to target shareholder for receipt of acquirer shares, but not for receipt of other consideration, in § 368 acquisition); Rev. Rul. 2000-5, 2000-1 C.B. 436 (transaction categorized as a merger by state law was not a merger for federal purposes because the transaction was divisive).

majority of the target's directors, should suffice.¹⁵⁸ Or, in the alternative one could use a control test that rests on the percentage of stock necessary under state law to pass fundamental changes to the target's business structure, such as amendments to a company's charter, a merger, an asset sale, or dissolution. One could also argue that the target's nonvoting common stock ought to be added to the test, which would require a percentage of the target voting stock to be matched by a similar percentage of all equity (or equity minus nonvoting preferred stock) by total value.¹⁵⁹ Including nonvoting stock in the measure of control would prevent the parties to a reorganization from covertly dividing the target through a creative use of nonvoting shares.

IV. A NORMATIVE RESPONSE

As an alternative to the pragmatic control test described in Part III, we offer a second approach, one that is characteristically not pragmatic and has different normative goals. Through the lens of realization as it relates to an entity view of corporations, the proposal's normative goals include elevating substance over form, loosening federal ties to state corporation laws, and modernizing nonrecognition by robustly conceptualizing corporations as entities rather than aggregates of shareholders.

In his influential article, *Mergers, Taxes, and Historical Realism*, Steven Bank argued that nonrecognition treatment afforded to mergers is an embodiment of the compromise between consumption and accretion views of the income tax.¹⁶⁰ Early advocates of a consumption-type income tax believed that growth of capital should not be taxed, while advocates of an accretion-type income tax believed that growth of capital should be taxed currently.¹⁶¹ Realization and recognition requirements of the Code struck a balance between these positions by requiring taxation of growth, but only when a taxpayer severs it from the original investment.¹⁶²

¹⁵⁸ This calculus should include dilution by all outstanding convertible and derivative instruments. The legal control test would require an absolute majority of the outstanding stock. An "effective majority" would require a smaller majority that, in light of the dispersal of the shares, is enough to win voting contests that require a majority of those who actually vote at shareholder meetings.

¹⁵⁹ A 1999 Treasury proposal would have conformed the definition of control in Section 368 to that in Section 1504. See Am. Bar Assoc. Section of Taxation, *Comments on Proposed Section 368(c) Definition of Corporate Control*, 83 TAX NOTES 1357, 1357 (1999). Section 1504(a)(4) excludes certain nonvoting preferred shares from the definition of "stock" for purposes of determining whether corporations are part of an affiliated group. See Jerome Tannenbaum, *Nonvoting Stock for the Consolidated Return*, 29 TAXES 679, 679 (1951).

¹⁶⁰ See Bank, *supra* note 16.

¹⁶¹ *Id.* at 45–51.

¹⁶² *Id.* at 67–69.

Nonrecognition in the merger context may be conceptualized as a part of that compromise.¹⁶³

Viewing § 368 in light of that compromise reveals an alternative approach that Congress might have taken in the context of corporate acquisitions. This approach is built on three points. First, a more robust espousal of the entity view would have separated the question of shareholder nonrecognition from that of target nonrecognition. Second, a more robust view of realization and recognition could have led Congress to draft § 368 not by legislating particular deals, i.e. the merger, stock swap, and asset acquisitions, but instead by identifying aspects common to all deals that are relevant to realization and recognition. Third, if Congress had focused less on form and more on substance, it could have taken a normative approach *ex ante* rather than a remedial approach *ex post* to address the evolution of corporate acquisition practice.

A. *Prioritizing the Entity View*

The structure of § 368, which has remained essentially unchanged since the 1930s,¹⁶⁴ reflects a less-than-robust conception of corporations as entities separate from their shareholders. This is expected, since ideas about income and corporations were unsettled in the income tax's early years.¹⁶⁵ Rather than making separate inquiries into whether shareholders and the target should pay tax, § 368 focuses on the form of the entire transaction, asking when the transaction as a whole justifies nonrecognition for all of the parties. But under modern law, shareholders and corporations are independent actors, and outside of the reorganization context, the recognition of income by one generally does not implicate the other.

1. *COI Should Not Be a Factor in Target Nonrecognition.*—The triangular merger rules' (indeed, all of § 368's) embodiment of an incomplete conception of the entity view of corporations is not without consequences. For instance, continued application of COI requirements, which require a portion of the target's shareholders to become acquirer shareholders,¹⁶⁶ reflects the idea that a corporation is an aggregation of its shareholders rather than a separate entity. Were tax law to view the corporation solely as an entity separate from its shareholders, there would be little need to insist on this form of continuity. Under an entity view, Shareholder *A*, who receives acquirer stock in exchange for target stock, is in the same financial position postmerger regardless of whether

¹⁶³ See *id.* at 73. In theory, reorganization merely changes the form of a taxpayer's investment rather than removing it from the market; therefore, it may be an inappropriate time to levy tax.

¹⁶⁴ *Id.* at 12.

¹⁶⁵ See Kornhauser, *supra* note 16, at 57; Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1225 (2004).

¹⁶⁶ Treas. Reg. § 1.368-1(e)(1) (2011).

Shareholder *B* does the same.¹⁶⁷ Put more generally, an individual shareholder's economic position is not directly affected by the identity of other shareholders postmerger. The same is true for the target. Its identity, assets, and contracts in place are not legally dependent upon the identity of its shareholders. Requiring continuity of Shareholder *B*'s interest in the target postmerger makes little sense as a bar to Shareholder *A*'s nonrecognition, unless one believes that corporations are aggregates of their shareholders. While one may argue that the identity of the corporation is bound up in the identity of its shareholders, and that the target ceases to be itself when a significant number of its shares change hands, by law, the target is something more than an aggregation of shareholders, and its existence does not depend on their identity.¹⁶⁸ A stronger conception of the corporation as an entity counsels against the use of COI as a bar to shareholder nonrecognition.

COI is also irrelevant to target nonrecognition. A target corporation is a separate person under state law and can act independently of its shareholders in most instances. Its business is not tied to their identity, except perhaps in the case of closely held businesses. In a merger, its contracts may remain in place and it may continue to act in the market as a going concern. At the moment of the merger, its assets remain in productive association with one another, even though the identity and number of its shareholders have changed.¹⁶⁹ The COI requirement makes little sense in this context. The question of whether the target has experienced realization should equate to whether the target has severed growth or loss from its capital. Rather than focusing on COI, recognition should attach to actions that disassemble the target's business or cash out its investments. Here, the COBE requirement, or the requirement that an acquirer obtain substantially all of the target's assets, makes more sense than the COI requirement.

B. Focusing on Realization

Congress also might have taken a different approach to § 368 if it had focused more heavily on realization. In asking how a stronger emphasis on realization would affect separate tests for shareholder and target nonrecognition, we refer to our shareholder analysis in Part II.B and accept the premise that realization is appropriate when a taxpayer has severed

¹⁶⁷ It goes without saying that the shareholder remains concerned with its percentage ownership in the underlying entity.

¹⁶⁸ The argument that corporate identity depends on the identity of shareholders was refuted in *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75, 103 (1995) (“[W]e must look not to the identity of the target’s shareholders, but rather to what the shares represented when the reorganization was completed.”).

¹⁶⁹ See *supra* Part II.A.

gains or losses from the assets that generated them.¹⁷⁰ Sale by a corporation of a single asset for cash obviously would result in realization. In contrast, if one corporation merges into another newly formed corporation containing no assets, and the acquirer disposes of none of the acquired assets, but continues to operate the target as though no merger had occurred, then realization is not appropriate. This is because the acquisition has not resulted in withdrawal of any of the target's gains from capital or its productive capacity from the market. But what about the range of examples that fall between these two extremes? A merger is rarely in either of these two categories, and a nonrecognition regime must distinguish an asset sale from the continuation of a target's business.

One way to distinguish between the sale of some of the target's assets and an acquisition of the target itself is to focus upon an embodiment of the target that is not governed by its formal incorporation under state law.¹⁷¹ There is a particular deployment of assets, employees, and opportunities that make up the target corporation and which might be acquired wholesale. That deployment will be different for each target, and it does not depend upon the formalities of state law. In other words, tax law should ask whether the acquirer has purchased some of the target's assets, or whether it has acquired the target itself—that unique collection of attributes that make the target a business. Consider Professor Shaviro's description of a corporation as having “a kind of internal character and arc of continuously unfolding historical development that no individual can easily alter.”¹⁷² This language clearly depicts a unique entity, the essence of which might be carried into an acquirer, and the existence of which does not depend upon state formalization.

It is the transfer of this “essence” of target that should be the hallmark of nonrecognition for the target. In a qualifying acquisition of the target, the cognizable essence of the target is transferred to an acquirer. Although the target shareholders have alienated their interests, gains and losses of the target have not been severed from the capital or productive capacity that generated them, and while the target's formal identity may not survive the acquisition, the going concern of the target (not simply a pile of assets, but a deployment of assets and opportunities for the production of profit) will. Forcing recognition in this circumstance would be inappropriate for many of the traditional reasons given for nonrecognition in corporate acquisitions, such as federal aversion to taxing paper gains, or the creation of cash flow problems for a target, the assets of which are fully deployed or illiquid. Furthermore, when an asset is sold following a merger, the sale is

¹⁷⁰ See Kornhauser, *supra* note 16, at 55 (defining realization as a transaction “which changes the taxpayer's relationship to the asset”).

¹⁷¹ For instance, Professor Coven has suggested providing nonrecognition to “the transfer of an entire business activity.” See Coven, *supra* note 131.

¹⁷² See SHAVIRO, *supra* note 134, at 10.

fully taxable.¹⁷³ Where the target transfers its entire self in a corporate acquisition, it has not changed the relationship of its assets nor severed gain from them by changing their deployment. It has, instead, changed its relationship with its shareholders, which should not be a taxable event.

Still, a tax-based conceptualization of the corporation is elusive. Describing the essence of a corporation without resort to state-level formalities pushes toward ephemera, and a standard such as we have described is unworkable. By its very nature, the essence of a target is beyond statutory comprehension and any attempt to capture it would give the government immense discretion while giving taxpayers negligible guidance. There are, however, second-best alternatives. For instance, a strong showing of continuity of business interest or transfer of a substantial going concern could both serve as signals that the target survived acquisition even though its formal existence may have been extinguished. We do not seek here to fully describe such a test but raise it as the logical endpoint of our normative inquiry.

C. *Placing Substance over Form*

As described above, Congress's adoption of a more robust view of realization and of the corporation as an entity rather than an aggregate of its shareholders could have led it to draft § 368 by identifying aspects common to all deals that are relevant to realization and recognition. For instance, in all nonrecognition acquisitions, shareholders receive some substantial level of equity in the acquirer, providing a basis for nonrecognition of shareholder gain where stock is traded for stock. And in all nonrecognition acquisitions, the going concern embodied by the target is preserved in some form at the time of acquisition, providing a basis for nonrecognition of target gain.¹⁷⁴ Focus on the fundamental underpinnings of realization reveals that nonrecognition of the shareholders need not correspond to nonrecognition of the target. Furthermore, in a reimagined nonrecognition regime, focusing on realization would lead to substance-based rather than form-based rules. Section 368 embodies a transactional elective available through compliance with or departure from clearly defined rules, allowing acquirers to vary the substance of their transaction from its form. A standard based on fundamental notions of realization, however, would focus solely on substance, asking whether a taxpayer (either the shareholder or the target) has severed gain or loss from its underlying investment. This inquiry would decouple federal tax law from transactional forms given by state law or invented by innovative counsel.¹⁷⁵

¹⁷³ See I.R.C. § 1001 (2012).

¹⁷⁴ See, e.g., Fed. Reg. § 1.368-2 (as amended in 2010) (describing continuity of propriety interest and continuity of business enterprise requirements).

¹⁷⁵ State law would still limit transactional forms and procedures. Federal tax law, however, has different goals than those of state corporate codes. State codes authorize corporations to enter into deals

A substantive test as described above, applied separately to the target and its individual shareholders, would accomplish this goal. Only when form and procedure are relevant to realization of the particular taxpayer at issue should they be relevant to nonrecognition.

CONCLUSION

Over the past one hundred years, federal tax law on reorganizations has failed to keep up with the evolution of state law on mergers and acquisitions. The most popular modern acquisition form, a triangular merger, still remains an afterthought in the evolution of tax law on reorganization. The ubiquitous use of triangular mergers demands that tax doctrine on the acquisition type be reexamined and reformed.

Yet by peering into the Pandora's box of tax-preferred reorganizations, one must necessarily grapple with the most fundamental issues of an income tax. What is (or ought to be) "income"? What principles are behind the nonrecognition of income? How does one reconcile nonrecognition in some cases with recognition in others? What role should state law play in the development of federal law? What justifies the fiction of corporate personhood, and should we continue or contest the double taxation of corporate profits?

When asking why the forward triangular reorganization is treated differently from the reverse, or why either of these acquisitions is treated differently from a straight A reorganization, deep questions emerge. Among them is why the form of these transactions matters when determining whether shareholders or corporate parties to the transactions should be entitled to nonrecognition. This question, in turn, implicates form not only in the reorganization context, but also in the corporate tax more broadly. At the heart of the deepest problems in § 368, we find the fiction of corporate personhood juxtaposed with the fact of going concern, the conflict between aggregate and entity views of the corporation, and the false legislative presumption that corporate tax is born by the corporation.¹⁷⁶

The intertwined nature of state and federal law in the reorganization context has created fundamental problems. Federal respect for corporate personhood and forms of transactions between corporate persons has implicitly imported myriad state laws into the federal tax context. In a system where state law governs the form of transactions and in which form matters, the federal government is required to adjust for the novel use of old forms or the creation of new ones. It must do this because it has taken

and specify how corporate authority is exercised and divided among boards of directors and shareholders. These goals are only tangentially related to the goal of taxing "income" in the context of the corporate acquisitions.

¹⁷⁶ See Adam H. Rosenzweig, *A Corporate Tax for the Next One Hundred Years: A Proposal for a Dynamic, Self-adjusting Corporate Tax Rate*, 108 NW. U. L. REV. 1029 (2014).

form as the starting point of its assessment and because the federal government does not, itself, govern form. And because there are fifty states and only one federal government, it is unrealistic to expect the federal government to keep pace in a form-based regime. It is also unrealistic to expect it to comprehend and account for normative considerations each time a novel form appears.

Congress has sought consistency in this exercise, sometimes at the expense of normative coherence. In dealing with the evolution of form in state law, therefore, the federal government has often created rules by analogy. As a result, the rules applicable to triangular mergers are doubly hidebound, containing an unnecessary amount of complexity and overlap.

If, over the past one hundred years, Congress, the Treasury, and the IRS had viewed the taxation of corporate acquisitions as a question of substance—namely, whether realization had occurred and whether recognition was justified—rather than a question of form, the reorganization statute might look very different.¹⁷⁷ Congress may have, instead, chosen statutes that are minimalist and communicate core normative positions on the identity of income and the role of entities in an income tax system. This would have decoupled the taxation of reorganizations from innovations of state law, relieving pressure on the federal government to constantly amend within the constraints of existing law.

This leads us, then, to our final recommendation. In its next one hundred years, Congress should strive to pry the corporate income tax free from state laws on corporate personhood and governance, focusing not on form, but instead deciding on substance what income is, to whom it should be attributed, and when it should be taxed.

¹⁷⁷ We also note the profound effect double taxation has on the question of nonrecognition and leave that issue for another day.

