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Taxation of Corporate Reorganizations

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> You can do anything in Subchapter C. [Subchapter C contains reorganization and other corporate provisions]
>
> —Martin Ginsburg

I. Introduction

In designing tax laws for developing or transition countries, drafters often neglect, and sometimes completely forget, provisions for corporate[1] reorganizations.[2] This chapter reviews the forms of corporate reorganization that might be available under company law and the tax consequences of reorganizations in the absence of special tax rules.[3] It then considers the tax

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Note: Victor Thuronyi contributed to the writing of this chapter.

[1]This chapter assumes that the entities being reorganized are corporations or share companies. As discussed in ch. 21, the tax on legal entities may tax as separate entities various organizations (e.g., forms of partnership) that are not share companies. In countries with such rules, appropriate reference to the legal forms that reorganizations of such organizations take will have to be made in the rules on reorganizations. *E.g.,* FRA CGI § 160 (refers to *droits sociaux* (interests in a company), which is a broader term than *actions* (shares)). There may be substantial differences in the legal form taken by such reorganizations, compared with the reorganization of share companies. To avoid complicating the discussion, we will not address further the necessary adaptations that would have to be made in such cases.

[2]EST IT § 25 provides for nonrecognition treatment for reorganizations in accordance with conditions established by the Minister of Finance. The tax codes of Kazakhstan and the Kyrgyz Republic do not contain provisions concerning reorganization, nor does the income tax decree of Saudi Arabia or the profit tax decree of Romania. In some countries, the absence of provisions relating to reorganization can be explained by the fact that capital gains are not subject to tax. *See also infra* note 45.

[3]Further discussion on comparative law can be found in Tax Consequences of International Acquisitions and Business Combinations, 77b Cahiers de droit fiscal international (1992)(since many international acquisitions take the form of *taxable* acquisitions of shares or assets, this work is a good source for discussion of taxable acquisitions; it also deals with taxfree acquisitions and with international business combinations, as well as with related tax planning issues such as the deductibility of acquisition indebtedness and the impact of imputation systems on acquisition strategies); Peter Begg, Corporate Acquisitions and Mergers (looseleaf 1997)(covers tax, corporate law, employment law, and regulatory matters in the U.K. and the other EU countries); Svetlana Almakaeva, *Effects of Russian Tax Treaties and the EC Parent-Subsidiary Directive on the Tax Planning Strategies of European Multinational Groups Investing in Russia*, 23 Review of Central and East European Law 77 (1997). *See also infra* note 15.

treatment of reorganizations if there are special nonrecognition[4] rules and the considerations in designing those tax rules. The discussion supports the desirability of having at least some basic reorganization provisions if policymakers consider that the tax system should not discourage corporate restructuring.

In transition countries, reorganizations can occur as part of the privatization process or thereafter as the ownership of companies changes hands. Even when the top priority is to make existing businesses work rather than to reorganize them through merger or division, it is necessary to think from the start about rules in civil or commercial law that would allow mergers, acquisitions, or divisions, and about their tax implications. It is better not to wait until the first practical cases arise. In developing countries, reorganizations may or may not take place very often. Even if they are not frequent, however, it makes sense to have a set of rules in place so that business reorganizations are not impeded by the tax system. In addition, foreign investors will be more confident when they notice that the legal system in general, and the tax system in particular, provides for such transactions, to which they are used in their own business environment.

Industrial countries generally have specific rules for tax-free reorganizations. In the absence of such rules, business reorganizations could lead to taxable transfers of assets or shares. The resulting tax liabilities could be so large as to obstruct business reorganizations. The general policy view in most countries is that it is economically not efficient to tax corporate reorganizations, because taxation would discourage reorganizations. Where there is a continuation of business activities and of the interest of the shareholders in the company, a corporate reorganization may be considered as tantamount to a legal restructuring of the same business, which does not constitute a sufficient change in economic position to merit taxation.

In developing and transition countries, the basic issues in designing the rules for corporate reorganizations are the same, although these countries will generally want to adopt rules that are as simple as possible given that the volume of reorganizations will be relatively small. In addition, special issues will be involved in the treatment of investment funds and in privatization, to which we refer in this chapter from time to time.[5]

II. Forms of Corporate Reorganization

Reorganization is used here in a general way to describe transactions involving significant changes in the legal or economic structure of one or more business enterprises. In some countries neither company law nor tax law defines the term, although specific forms of reorganization may be defined,[6] while other countries have a general tax law concept of reorganization.[7]

[4]This term is explained *supra* ch. 16, sec. V(B)(7).

[5]*See* Yolanda Kodrzycki & Eric Zolt, *Tax Issues Arising from Privatization in the Formerly Socialist Countries*, 25 Law & Policy in Int'l Business 609 (1994). *See* ch. 21 for taxation of investment funds.

[6]Canada has a definition of an amalgamation in sec. 87 (1) ITA, but no overall definition. Council Directive of July 23, 1990 (90/434/EEC) refers separately to "mergers, divisions, transfers of assets, and exchanges of shares."

The forms of reorganization are described below in general terms.[8] Because of differences in company law, the descriptions will not be accurate for some jurisdictions. However, most jurisdictions provide for transactions that more or less correspond to the forms described. In drafting for a specific country, it will of course be necessary to consult the company law, special reorganization law (if any), bankruptcy law, civil law, and other applicable commercial laws of that jurisdiction.

The following parties[9] to a reorganization can be identified: (1) the acquired or transferor[10] company, (2) the shareholders of the transferor, (3) the acquiring or transferee company, (4) the shareholders of the transferee, and (5) all other persons, in particular the creditors, having a contractual or other legal relationship with the transferor or transferee. Reorganizations can be distinguished according to whether or not a legal entity party to the reorganization disappears as part of the transaction. In mergers, consolidations, and corporate divisions, one of the parties may disappear by the mere fact of the transaction. In asset and share[11] acquisitions, the transferor may or may not disappear depending on whether it is liquidated or not. Whether an entity disappears may be relevant for several issues, including the taxation of shareholders and the carryover of tax attributes.

[hereinafter Merger Taxation Directive]. Similarly, the French tax code refers separately to a merger (*fusion*), CGI §§ 160 I *ter,* 210A, division (*scission*), CGI § 160 I *ter*, and a transfer of assets (*apport partiel d'actif*), CGI § 210B.

[7]In the United States, reorganizations are defined for tax purposes in IRC § 368. In Germany, for corporate reorganizations in general the word *Umwandlung* is used. Reorganizations are regulated in the *Umwandlungsgesetz* (UmwG) (Reorganization Law) and the Reorganization Tax Law; *see* Klaus Tipke & Joachim Lang, Steuerrecht 432 (1991); Dieter Endres & Pilny, *Germany Releases Draft Regulation on the Reorganization Tax Act*, Tax Notes Int'l 1867 (June 9, 1997).

[8]Other corporation-shareholder transactions relevant to reorganizations— liquidations and redemption of shares— are dealt with in ch. 19. Nonrecognition rules for the incorporation of sole proprietorships, as well as other corporate and partnership formation transactions, are dealt with in ch. 16.

[9]Not all of the listed persons are parties in some reorganizations. For example, the shareholders of the acquiring company may not be parties if their share ownership does not change in the reorganization. The list given in the text is a broad concept of party used in a general sense. A somewhat narrower, more technical concept (which includes only the corporations involved) is defined in USA IRC § 368(b).

[10]Throughout this chapter, we use the term "transferor" to indicate the person or entity transferring assets, shares, securities, or other forms of consideration to another person and the term "transferee" to indicate the person to which such consideration is transferred. The transferor company can also be indicated as the acquired, merged, or divided company, while the transferee company can be indicated as the acquiring, surviving, or newly established company. The terms transferor and transferee are preferred, because they have the same meaning in different kinds of reorganizations.

[11]This chapter refers to "shares," whose American equivalent is "stock."

A. Merger

A merger, also called amalgamation,[12] is a transaction in which all or substantially all the assets and liabilities of one or more transferor companies are transferred to a single transferee company, whereby the transferor companies cease to exist by operation of law, that is, not on the basis of a consensual agreement between parties and not through liquidation. In most countries this transfer must take place exclusively or substantially in exchange for shares.[13]

B. Consolidation

A consolidation[14] is a transaction whereby two or more companies transfer their assets and liabilities to a single newly established company. The basic legal mechanism for a consolidation is identical to that of a merger: all or substantially all of the assets are transferred by operation of law in exchange for shares. The only difference is that in a merger the transferee company is a preexisting company, while in a consolidation the transferee is a newly established company.

C. Corporate Divisions

A corporate division is the opposite of a merger or consolidation: all or substantially all the assets of one company are transferred in exchange for shares to at least two or more newly established or preexisting companies, unless these assets are already in the hands of a subsidiary. Three types of divisive reorganizations can be identified.[15] In a spin-off, the shares of a subsidiary are distributed to the shareholders of the parent company. In a split-off, the shares of a subsidiary are distributed in exchange for the surrender of shares of the parent company. In a split-up, the parent company distributes its shares in two or more subsidiaries in complete liquidation.

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[12]CAN ITA § 87. In French this transaction is called *absorption*. In German, either *Verschmelzung* or *Fusion* is used. Directive 78/855/EEC, art. 3 uses the term "merger by acquisition."

[13]In the draft merger directive of the European Union a merger or consolidation is valid only when the transfer of the net value is substantially in exchange for shares, *see* §§ 2-4 draft directive, referring to Directive 78/855/EEC, which allows a cash payment of up to 10 percent of the nominal value of the shares issued. In the United States, however, there are several states in which a merger in the sense of a legal transfer of all assets and liabilities of a company that immediately ceases to exist is possible without consideration being paid in shares.

[14]In French, this is called a *fusion*. *See* FRA CGI, Annex II, § 301B. Directive 78/855/EEC, art. 4, uses the term "merger by the formation of a new company."

[15]*See* Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.01 (1987); Albert Rädler, *General Report, National and International Consequences of Demergers,* 79b Cahiers de droit fiscal international 557, 558, 565 (1994) (Readers who want to learn more about the comparative tax law of corporate divisions are referred to this work, including the accompanying country reports.)

[15]Under USA IRC § 368 (a)(1) (C), (G), the transferor in an assets acquisition is generally required to liquidate or is treated as if a complete liquidation had taken place. *See* Bittker & Eustice, *supra* note 15, ¶ 14.14. An asset acquisition without liquidation is possible under NLD Vpb § 14(2) (definition of an asset acquisition (*bedrijfsfusie*) for tax purposes) and BEL CIR art. 46 § 1 (contribution of branch or of all assets in exchange for shares).

D. Asset Acquisition

An asset acquisition is a transfer of assets and liabilities by one or more companies to a newly established or preexisting company in exchange for any form of consideration (shares, securities, cash, assets in kind, or transfer of liabilities). In an asset acquisition, the transferor company may continue to exist after the transfer or may distribute the proceeds to its shareholders in a complete liquidation. In the latter case, the effect of the transaction will be very close to a formal merger. Since reorganizations deal with substantial and significant structural economic and legal changes, in order to qualify as a reorganization, an asset acquisition will normally have to involve a transfer of substantially all of the transferor's assets. The transfer of a smaller portion of the assets is treated as a sale of these assets, not as a reorganization.

E. Share Acquisition

A share acquisition is the transfer of shares of a company to a newly established or pre-existing company in exchange for any form of consideration (shares, securities, cash, assets in kind, or assumption of liabilities). Again, the transaction will be considered to be a reorganization only if the transfer of shares involves a substantial holding, so that the transferee company acquires an important say in the affairs of the acquired company. The transfer of shares may or may not be followed by the liquidation of the acquired company into the transferee company.[16]

F. Change in Seat or Form

A change in seat is a change in the jurisdiction of incorporation, while a change in form is a change from one type of company to another. Both consist of legal structural changes, but do not necessarily involve economic changes in the way the business of the company is conducted. The assets and liabilities and the economic activity of the company whose seat or form is changed remain unchanged. When the seat of a company is moved from one country to another, or when the form of the company is changed, the company law may provide that the company is liquidated and that a new company is established.[17] Generally speaking, however, when the seat

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[16]The share acquisition is the most common form of corporate reorganization in the Netherlands; *see* Van Soest, Inkomstenbelasting 470 (1990); its tax requirements are defined in NLD IB § 14b(2). In France the share acquisition is called *fusion à l'anglaise* (!) and is regulated in CGI Annex II § 301C-I, stating that the acquiring company must acquire at least 75 percent of the shares of the acquired company. In the United States the share acquisition is regulated in IRC § 368 (a) (1) (B), requiring a share of at least 80 percent in the acquired company.

[17]In Switzerland, conversion of a GmbH into an AG is not possible without liquidation. *See* Company Law in Europe: Switzerland § 22 (Peter Meinhardt ed., 3rd ed. 1981). Law No. 66-537 of July 24, 1966, § 154, *reprinted in* Code des Sociétés (Dalloz 1996) provides that a company may change its seat from one country to another if the host country has concluded a treaty with France permitting such a change without disturbing the legal personality of the company. It may not be possible under company law to change the seat of a company to another country. *See, e.g.,* Steven Schuit, *Business Organizations; Corporations, in* Dutch Business Law § 9.10[6] (Schuit, Romyn, and Zevenboom, eds. 1997) (impossible to transfer seat to another country except in extraordinary situations like war). In cases like this, the transfer of seat can be accomplished by forming a new corporation in the target country and merging the existing corporation into the new corporation or by contributing the shares of the existing company to the new company and then liquidating the existing company.

is moved within the same country or when the form is changed, most company laws stipulate that the legal identity of the company remains unchanged.[18]

G. Recapitalization

Recapitalizations are changes in the way a company is financed, that is, structural changes in its share capital or outstanding debt. As with most changes in seat or form, the legal identity of the company remains unchanged.

H. Bankruptcy Reorganizations

Bankruptcy reorganizations may take any of the forms described above, with the distinctive element that one or more companies are declared bankrupt and that as a consequence the outstanding debt of the companies involved is rescheduled. Although the emphasis is on the reorganization of the debt, reorganization of share capital may also be involved, as well as the liquidation of one or more corporate entities.

III. Taxable Reorganizations

This section considers the tax consequences of taxable reorganizations. The discussion is relevant in several contexts. First, the tax consequences discussed apply in the absence of special nonrecognition rules for reorganizations. This is relevant to countries that do not have such rules and that are considering whether they should be introduced. Second, even in countries that have nonrecognition rules, some reorganizations will be structured so as to fail to qualify under those rules and will accordingly be considered taxable reorganizations. Why it may be advantageous in certain situations for taxpayers to do so is discussed below. Finally, sometimes taxpayers will seek to structure a transaction so as to qualify for nonrecognition treatment, without meeting the requirements, so that the transaction is treated as taxable. And other transactions simply will not possess the required characteristics of a tax-free reorganization.

A. Tax Position of the Transferor Company

Regardless of how a reorganization is effectuated under company law, income tax systems as a general rule treat reorganizations in which the transferor company disappears as a transfer of assets and liabilities by the transferor to the transferee company. This transfer of assets is treated as a sale, from which any gain is taxable and any loss is deductible.

The amount of gain or loss is calculated in accordance with the normal income tax rules. Assuming that all assets are taxed according to the same rules, the gain or loss is calculated as

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[18]*See, e.g.,* FRA Code civil § 1844-3 (change from one type of company to another does not result in creation of a new legal person); P. Verrucoli, Italian Company Law 205-207 (association of persons can be converted into capital company and vice versa) (1977). *See also* Law No. 66-537, *supra* note 18, §§ 236-238 (providing for change from *société anonyme* to other forms); *id.* § 69 (providing for change from *société à responsabilité limitée* to other forms); Schuit, *supra* note 18, § 9.10[4](change in form does not affect continued existence of a corporation).

the difference between the total consideration received by the transferor in the form of shares, securities, cash, or other property and the tax basis of all assets transferred. The consequence of taxing such a transfer is that all profits and gains whose taxation had been deferred before the reorganization will become taxable.

Example

OLDCO TAX BALANCE SHEET[19]

Assets		Liabilities	
Inventory	$20,000	Capital	$30,000
Receivables	$20,000	Reserves	$20,000
Fixed assets	$60,000	Liabilities	$50,000
Total			$100,000

Note: Acquisition price: shares of Newco valued at $100,000 plus assumption of all liabilities, equals $150,000. Taxable profit: $150,000 minus $100,000 (tax basis of the assets on the balance sheet) equals $50,000.

The rate at which the acquired company's gain is taxed depends on the general rules for taxation of profits and capital gains. While in some systems capital gains are taxed at the same rate as ordinary profits, in others there are special arrangements for capital gains. Many countries tax ordinary profits and capital gains of companies at the same rate.[20] Capital gains on business assets are still taxed at preferential rates in Belgium, France, Greece, and Ireland, and recently the capital gains preference has been reintroduced in the United States. When a tax system provides for lower rates on capital assets, it is necessary to allocate the total consideration to the individual assets transferred. The greater the portion of the consideration allocated to capital assets, the lower the amount of tax.

The transferor and the transferee have conflicting interests in allocating the purchase price. The transferor will be interested in minimizing its tax burden by shifting the price to capital assets, whereas the transferee will be interested in recouping the acquisition cost as soon as possible through direct expenses, by shifting the acquisition price to items that are immediately deductible, like the cost of inventory.[21] However, the parties can often reach an

[19]The value for which assets are recorded in a company's accounts does not always coincide with the tax basis of the assets. This depends on the relationship between commercial accounting and tax accounting, which varies from country to country. *See supra* ch. 16, Appendix A.

[20]For a survey of the situation in the European Union, see Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 243 (1992) (Onno Ruding, Chairman) [hereinafter Ruding Committee Report].

[21]*See infra* sec. C(1).

agreement to optimize their joint tax situation at the expense of the government, particularly when both companies are members of the same corporate group.[22]

B. Tax Position of the Shareholders of the Transferor

1. Taxability of Shareholders

Whether the shareholders are taxed in a taxable reorganization is determined by the general rules on the taxation of capital gains. These rules vary in many tax systems depending on the category of taxpayer that realizes a capital gain and on the purpose for which the shares are held (business or private investment).[23]

Some countries tax all capital gains on shares regardless of who holds the shares and why the shares are held. Consequently, the transfer of the shares of the acquired company in exchange for the shares of the transferee company, bonds, cash, or other forms of compensation is a taxable event, absent special nonrecognition rules.[24]

In many other countries, however (in particular in the European Union, with the exception of the United Kingdom and the Scandanavian countries), individual shareholders are not taxed on the gains resulting from the sale of shares when the shares are held on a long-term basis for private investment.[25] The gains will also be exempt when realized by charities or other exempt organizations. In some countries, however, gains on shares are taxable when the individual shareholder holds a "substantial" share in a company.[26] When an individual shareholder holds shares for business purposes, practically all countries will tax the gain realized on the sale or exchange of the shares.

Shares held by companies are a special case. Many tax systems treat them as assets held for business purposes, and, consequently, any gain on the sale or exchange of shares is a taxable event. However, some countries (e.g., Belgium and Netherlands [27]) consider the gain realized on

[22]In a transaction between unrelated parties, one party can compensate the other party by an adjustment in the purchase price if the latter agrees to bear a greater tax burden. The problem of possible abuse in a transaction between related parties can be addressed through a general rule that gives the tax administration the power to readjust transfer prices between related taxpayers and in some cases (such as tax evasion) even between unrelated taxpayers, so as to reflect the fair market value of the transaction for tax purposes. Such a rule is not specific to reorganizations. *See* vol. 1, at 53; ch. 18 *supra*.

[23]*See supra* ch. 16, sec. VI(B).

[24]For example, in the United Kingdom there is a special capital gains tax, which also includes profits on shares held for private investment. *See* GBR TCGA §§ 2, 21.

[25]*See,* for a survey of capital gains tax rates for individual shareholders, Ruding Committee Report, *supra* note 21, at 273.

[26]*See* NLD IB § 39 (33 percent); BEL CIR § 90/9 (25 percent); FRA CGI § 160 (25 percent); DEU EstG § 17 (25 percent).

[27]*See* BEL CIR § 192; NLD Vpb § 13(1)(minimum 5 percent participation required); Van Soest, Inkomstenbelasting 454 (1990).

shares held by a company in a subsidiary company as the expression of the profits that have already been realized and taxed in the hands of the subsidiary. In such countries, capital gains realized on the transfer of shares held by the parent are exempt from tax.

2. Calculation of Taxable Gain

When the gain on the exchange of shares is taxable to the shareholder, the general rules applicable to calculating gains on the disposition of other assets will apply, together with any special rules as to the rate of tax and the deductibility of capital losses.[28] An exchange of shares, or a receipt of a distribution of the proceeds of the corporation's exchange of its assets, may also be treated as a dividend or a liquidating distribution, in which case any special rules applicable to those transactions will come into play.[29]

3. Cost Base of Assets Received in Exchange for Shares

The cost base of the new shares or other forms of consideration (other than cash) received by the shareholders in the exchange is also determined by ordinary tax rules. The value they receive for tax purposes is equal to their acquisition cost. The acquisition cost is the price agreed upon between the parties to the reorganization and should be equal to the value of the shares that are surrendered. In the reorganization agreement, that value should reflect the fair market value of the shares, and, if it does not, the value may be subject to correction under a general provision enabling the tax administration to adjust the price agreed upon between the parties.[30]

C. Tax Position of the Transferee

1. Cost Base of the Transferred Assets

After a taxable merger, the assets of the transferor will be valued in the hands of the transferee at the value that has been used to determine the transferor's tax liability in the merger or division, as discussed above in section B. Subsequent profits, depreciation, capital gains, and capital losses on assets will be calculated not on the basis of the old value that the assets had before the reorganization, but on the basis of the new value that was assigned to them in the merger or division. As a consequence, some of the assets of the transferee (assets transferred by the transferor) will be valued for tax purposes at current prices, while others (assets that the transferee owned before the reorganization) will reflect historic and depreciated values. Absent nonrecognition rules, in the case of an assets transfer, the tax law clearly takes a position of discontinuity. It considers the merger or division as a sale of assets for tax purposes, resulting in their revaluation.

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[28]*See supra* ch. 16, sec. V, VI(B).

[29]*See supra* ch. 19.

[30]*See supra* note 23.

A problem that is specific to reorganizations is the allocation of acquisition cost to goodwill. In most cases the total acquisition cost will exceed the total sum of the values of the individual assets. The difference is often accounted for as goodwill. Whether goodwill can be depreciated is determined by the general depreciation rules.[31] When depreciation is disallowed, the transferee company will try to minimize the amount allocated to goodwill; when it is allowed, the transferee will be tempted to inflate goodwill.

2. Transfer of Tax Benefits and Preferential Tax Regimes

In the case of taxable reorganizations in which the transferor company disappears (e.g., mergers and divisions), tax credits, exemptions, and other tax benefits enjoyed by the transferor are commonly canceled. The logic of this rule is apparent in cases of exemption. When an item has been temporarily exempt in the hands of the transferor (i.e. when taxation has been deferred), the logical consequence of taxing a merger is that all exempt items become subject to taxation at the time of the reorganization. Tax credits and other tax benefits from which the acquired company may have benefited are typically treated in the same way; that is, they expire with the transferor.[32]

In some cases, however, the benefit may be continued, subject to certain conditions. A typical example is an investment credit. Such a credit is typically recaptured[33] when the asset for which the credit has been granted is sold or transferred, but maintained when the asset continues to be used in the same business.[34] In a merger, the business situation has indeed not changed, because the same asset is still used in the same economic activity, but it is used by the legal entity succeeding the transferor company. However, the continuation of tax benefits in a taxable reorganization might be subject to a continuity-of-interest requirement, similar to the requirement applicable to tax-free reorganizations.[35]

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[31]*See supra* ch. 17, sec. II(E)(2).

[32]This rule is very often not explicitly spelled out in the statute, but follows from the general principle that tax characteristics cannot be transferred from one taxpayer to another unless the statute specifically provides for such a transfer. It is stated by negative implication in USA IRC § 381.

[33]When a credit is recaptured, the tax payable is increased by the amount recaptured. Recapture is known as clawback in the United Kingdom.

[34]*E.g.,* USA IRC §§ 50(a)(4), 381.

[35]*See infra* sec. IV.

3. Transfer of Tax Loss Carryovers

In the transfer of tax characteristics of the transferor company, tax loss carryovers play a special role.[36] To avoid a situation where profitable companies would chase loss companies to be able to use their tax loss carryovers in a merger or division, tax systems typically limit the carryover of tax losses from one company to another in a corporate reorganization.[37] In the case of a taxable transfer of assets, the transferee would in any event not inherit any loss carryovers of the transferor. In this case, the transferor could offset the loss against any gain realized on the transfer.

4. Transfer of Rights and Obligations in Litigation

The extent to which rights and obligations in tax litigation are transferred from the transferor to the transferee company may be decided by the rules of company law, contract law, or tax law.[38] When there is a formal merger transferring de jure all rights and obligations to the acquiring company, the latter will be entitled to immediately continue all tax protests, appeals, and other forms of litigation of the acquired company. Alternatively, the transferee may be liable on the basis of a contractual agreement or under special transferee liability provisions of the tax laws.[39]

5. Methods of Accounting

The transferor and transferee may use different methods of accounting (e.g., one may use cash and the other accrual, or one may use last in, first out (LIFO) and the other first in, first out (FIFO), or the two companies may use different accounting years). After the reorganization, this inconsistency must be resolved. It may be particularly difficult to resolve if there are rules in the tax law that if a company has started to use one method it cannot switch to another. Provision needs to be made to reconcile this rule with the fact that a reorganization will necessarily involve some change in accounting method when the parties use different methods. A purely formal approach would look to continuity of corporate identity: whichever company continues is the one that keeps its methods of accounting. When the successor is a newly formed company, does this mean that the taxpayer has the right to select whatever method it wants?

In addition to dealing with the question of what method of accounting the successor may use, the tax law should deal with the issue of transition. In a taxable reorganization, this is not difficult. For example, in the case of inventory accounting, the successor will typically continue its accounting method and will be treated as having purchased the inventory of the transferor. This inventory will be accounted for no differently from inventory purchased in the ordinary course of business. The result in the case of LIFO accounting in an inflationary situation can be

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[36]*See* discussion on tax loss carryovers in the general tax system, *supra* ch. 16.

[37]*E.g.,* USA IRC § 382.

[38]*See* Michael Saltzman, IRS Practice and Procedure ¶ 17.05 (2d ed. 1991).

[39]*E.g.,* USA IRC § 6901.

harsh, however, in that the difference between the fair market value of the inventory and its historic valuation (which will be artificially low because of the use of LIFO) is taxable.

D. Reorganizations Without Transfer of Assets or Shares

Some forms of reorganization deal with only one company, for example, with changes in corporate seat or form and various forms of recapitalization.

1. Change of Corporate Seat or Form

The change of corporate seat or form is a simple form of reorganization involving a change in the legal structure of the business but not its economic structure. A change in corporate seat should not have any tax consequence as long as the seat of the company stays within the same tax jurisdiction. When the seat changes from one tax jurisdiction to another, however, there may be full taxation of the company, as if it had distributed all its assets in a liquidating distribution.[40] This rule reflects the fact that after the move the company will no longer be subject to the national tax jurisdiction.

A mere change in corporate form (e.g., from a limited-liability company to a share company) should in principle not give rise to any tax liability. All assets and liabilities of the business remain within a single legal entity, albeit a different one, and the shareholders maintain their equity interest unchanged. In a few countries, a change of form may result in tax problems because company law may require a formal liquidation in order to change the company form, so that there is a legal transfer of assets and liabilities from the old company to the new.[41] Typically, however, the transfer is automatic and everything remains unchanged except for the company form. For tax purposes, the mere change__f company form should not be considered a taxable event, as long as the change is limited to the legal form of the company and its assets, capital, debt, and outstanding shares remain unchanged.

There may be a problem, however, when, as a result of a change in corporate form, the company changes its taxpayer status from corporate to flow-through treatment or vice versa.[42] It is clear that the tax law should provide for adjustments, when, as a result of a change in the form of the legal entity, its tax regime is also changed from one regime to the other. In such cases a

[40]Often the transaction is accomplished by forming a new corporation in the state where it is desired to move to and then merging the corporation into this new corporation. *See supra* note 18; Rufus Rhoades & Marshall Langer, 2 Income Taxation of Foreign-related Transactions § 7.02[8] (1996); Notice 94-46, 1994-1 C.B. 356. In some cases, a change in place of incorporation will not be taxable; *e.g.,* Rev. Rul. 87-27, 1987-1 C.B. 134 (liquidation of domestic corporation into a newly formed foreign corporation treated as a change in place of incorporation and hence as a Type F reorganization, which was tax free where the requirements of the regulations under IRC § 367(a) were satisfied).

[41]*See supra* note 18.

[42]*See infra* ch. 21.

change of form may be treated as a liquidation or an incorporation for tax purposes, resulting in taxation of any untaxed reserves or temporarily exempt profits.[43]

2. *Recapitalizations*

Increases and decreases in the capital of a company as a rule do not result in any tax liability for the company concerned. The principal tax issue in a recapitalization is whether the receipt of debt by the shareholders has the effect of the distribution of a dividend. If so, it should be taxable as a dividend absent a special rule. A distribution (through a decrease in capital) of what has been effectively paid in by the shareholders will commonly not be taxed as a dividend. Any other distribution should in principle be treated as a taxable dividend or liquidating distribution.

IV. Tax-Free Reorganizations

A. Introduction

Industrial countries typically have specific rules for tax-free reorganizations in their tax laws, and many developing and transition countries do so as well.[44] The objective of these rules is not to grant a tax exemption to the companies or shareholders involved, but rather to "neutralize" the tax consequences of the business reorganization, so that the reorganization involves neither a tax advantage nor a tax disadvantage. The principle of tax neutrality in business reorganization has two aspects. It implies (1) that no tax is levied at the time of the reorganization and (2) that, after the reorganization, the taxable profits of the transferee company and its shareholders are calculated on the basis of tax elements that were present in the transferor company and its shares immediately before the reorganization. The principle is one of deferral of tax on unrealized gains that exist at the time of the reorganization, not exemption of tax on these gains.

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[43]In the United States, when a C corporation (taxed as an entity) changes its status to that of S corporation (taxed on a flow-through basis), there is no immediate tax, but a tax is imposed on certain built-in gains of the C corporation if the S corporation realizes those gains within 10 years. *See* IRC § 1374; Bittker & Eustice, *supra* note 15, ¶ 6.07. Germany now allows a tax-free conversion of a corporation into a partnership. *See* Endres & Pilny, *supra* note 6. (This should be seen in the context of Germany having abolished the last remnant of economic double taxation.—L.M.)

[44]*See generally* The International Guide to Mergers and Acquisitions (Eric Tomsett et al., eds., IBFD) (looseleaf 1993-96) (covers most of the OECD countries as well as Argentina, Brazil, Singapore, and South Africa). See the Oct. 13, 1997, issue of Tax Notes International for discussion of rules concerning acquisition of companies in the Netherlands, France, Germany, and the United Kingdom. *See also supra* note 2. In Thailand, reorganizations are taxable. *See* THA RC §§ 72-74. The State Tax Administration of the People's Republic of China has recently issued circulars providing guidance on reorganizations, which provide that certain transactions may be carried out on a tax-free basis. *See* May Huang, Betty Ko, and Alan Tsoi, *China Issues Rules on Tax-Free Corporate Reorganizations*, 15 Tax Notes Int'l 543 (Aug. 18, 1997). In the case of Indonesia, Japan, and Korea, the opportunities for tax-free reorganizations seem to be quite limited. *See* Richard Weisman et al., *Structuring Transactions in Asian Countries: Tax Considerations for Cross-Border Mergers and Acquisitions*, 15 Tax Notes Int'l 215 (1997); Hugh Ault et al., Comparative Income Taxation 330, 339 (1997). Tax-free reorganizations and corporate divisions are allowed in Israel. *See* Arye Lapidoth, *The Israeli 1993 Income Tax Reform Relating to Mergers and Divisions of Companies,* Intertax 202 (1995).

B. Conditions for a Tax-Free Reorganization

The detailed rules setting conditions for tax-free reorganizations vary considerably from one country to another, but can be summarized in two basic conditions: (1) continuity of business enterprise and (2) continuity of shareholder interest. Opinions will vary as to the required degree of continuity, but all tax systems allowing tax-free reorganizations will (or should) impose these two basic conditions in one form or another. Doing otherwise would open enormous opportunities for tax avoidance, because it would allow the transferor company and its shareholders to finally dispose of all or part of their assets or their equity interest in a company through a tax-exempt merger or division without paying any tax. In some countries, the tax exemption is also made conditional upon the existence of a bona fide commercial or business purpose[45] or on the absence of tax avoidance.[46]

1. Conditions Set in Tax Law or in Company Law

Two different techniques are used in varying degrees to impose conditions on a tax-free reorganization: (1) autonomous conditions provided by tax law, and (2) conditions for a reorganization imposed by company law. Sometimes there is a combination of the two.

The advantage of having independent conditions in the tax code is obvious. Regardless of the legal form in which the parties may structure the reorganization, it should benefit from tax exemption only if it meets conditions set in tax law.[47] In addition, as is generally the case when one law refers to another, any reference to company law can be problematic because if there is a change in the conditions of company law there will be a simultaneous change in the conditions for tax exemption. Because the drafters of company law are often not tax experts, changes in company law may lead to unexpected surprises in tax law.

2. Degree of Continuity

The degree of required continuity of shareholder interest determines the degree of flexibility that the parties have in negotiating a tax-free reorganization. When, in an asset acquisition, company law or tax law subjects a tax-free reorganization to the condition that all assets and liabilities must be transferred and that such transfer is compensated exclusively in

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[45] *See* BEL CIR art. 211 § 1, 2 al. 3 ; GBR TCGA § 137 (1). In the United States, this is the result under the case law.

[46] *E.g.,* Merger Taxation Directive, *supra* note 6, art. 11.

[47] An example of independent conditions in the tax code is the type C reorganization in USA IRC § 368 (a)(1)(C): transfer of substantially all the assets of one company to another company solely in exchange for all or part of the voting stock of the company acquiring the assets. This definition does not refer to any rule in company law, since this differs from state to state. *See infra* note 49. For specific tax conditions for exemption, *see* NLD Vpb § 14; A.J. Van Soest, Belastingen 511 (Arnhem 1995); FRA CGI Annex II § 301B- 301F; Merger Taxation Directive, *supra* note 6, art. 2.

voting shares, the room for introducing changes in the way of doing business at the occasion of a reorganization is very limited.

Yet there are good business reasons to grant some leeway to the parties to the reorganization to make the necessary changes in the conduct of business or in the distribution of the property interests of the shareholders. As far as the transfer of assets is concerned, the transferor company often maintains some assets that are totally unattractive to the transferee company or for which it has no use (e.g., old equipment, dilapidated buildings, or scrap) and for which it is not prepared to pay. If the condition for tax exemption is that all assets need to be transferred, the transferee company will pay a higher price than is economically justified for the transfer and it will try to shed the useless assets after the merger.

A similar problem arises with the continuity of the shareholder's interest. Particularly when a small company is merged into a big one and the shareholders of the former receive only a small fraction of the total shares outstanding in the new company, they may prefer to sell their shares. In other cases, depending on the rules in company law, minority shareholders who are opposed to the merger may wish to exercise their rights to be bought out and receive the fair market value of their shares in cash. When the condition for tax exemption requires compensation of all the shareholders in voting shares of the acquiring company, this means that if the merger goes through, the buyout of the minority shareholders will result in a taxable merger. When this is the situation, the minority shareholders in effect hold a veto power over the merger being tax free. Therefore, the room left in the tax law or the company law for compensation in forms other than voting shares is very important.

An example of a statute that leaves sufficient flexibility with respect to the transfer of assets and the compensation in shares in a merger is the U.S. Internal Revenue Code. The text of the statute does not impose any hard and fast conditions, but requires only that the reorganization take the form of a merger under state law.[48] Conditions of continuity of the proprietary interest of the shareholders and of the continuity of business activity have been set by case law and are therefore rather flexible.[49]

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[48]*See* USA IRC §368(a)(1)(A). Under the U.S. federal system, the states are responsible for the general civil law, including company law. This has perhaps contributed to the flexibility of the federal tax law, as it must accommodate differences in company law among the states, and also explains why in the United States the requirements for a merger to be tax free are found in tax law rather than in company law.

[49]*See* Bittker & Eustice, *supra* note 15, ¶14.11; John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Reilly Oil Co. v. C.I.R., 189 F2d. 382 (5th Cir. 1951). USA IRC § 368 (a)(1)(A) defines a "merger" as a tax-free reorganization. What a merger is, is determined by company law. However, the United States has many different types of company law, because company law is not federal law but state law. In some states, there is even a valid merger when all or substantially all of the assets are transferred from one company to another, regardless of the form of compensation that is paid for a transfer. This implies that when the major part or even all of the assets of a company are transferred for cash there may be a merger under state law. This is unacceptable for tax purposes, because it would lead to a tax-free sale of most of the assets and the shares in the transferor company and lead to a serious breach in the principle of continuity. Therefore in addition to the reference made to a "merger" in the sense of the company law, there is an additional condition in the case law, only for tax purposes, that the shareholders must continue a substantial interest in the transferee company. *See* Cortland Specialty Co. v. C.I.R. 60 F.2d 937 (2d Cir. 1932); Commissioner v. Gilmore's Estate 130 F.2d 791 (3d Cir. 1942); Roebling v. Commissioner, 143 F.2d 810 (3d Cir. 1944).

Generally, a merger will qualify as tax free in the United States if at least half of the net value of the transferor company is remunerated in shares of the acquiring company.[50] As far as the continuity of the business activities of the transferor company is concerned, case law permits nonoperating assets to be excluded from those transferred in the merger and leaves room for changes in business activity.[51] This approach leaves enough room to accommodate the demands of minority shareholders who ask for the redemption of their shares at the time of the merger.

The requirements for other types of reorganizations in the U.S. Internal Revenue Code are more strict and mechanical. For example, in a type C reorganization,[52] the transfer of assets must cover "substantially all" assets, and at least 80 percent of the remuneration for the assets transferred, not taking into account the transfer of liabilities, must consist of voting shares of the acquiring company. Yet, these requirements for a tax-free merger leave room to shed some of the useless assets and to buy out minority shareholders.[53]

An example of a far stricter application of the principle of continuity can be found in the European Union directive on the taxation of cross-border mergers.[54] In defining a merger, the directive refers to a "legal merger." This concept has been developed in the draft directive on cross-border mergers in company law.[55] The directive requires that all assets and liabilities, without exception, be transferred to the acquiring company. This requirement is of course closely linked to the idea that the acquiring company is the universal legal successor to the acquired company and therefore acquires title to all assets and liabilities of the latter without exception. This concept leaves little room for shedding some useless assets or for changing the conduct of business at the time of the merger.

Similar restrictions apply to the continuity of the shareholder's interest. The part of the remuneration that can be paid in a form other than shares of the acquiring company is limited to 10 percent of the nominal value of the capital increase that is necessary to compensate for the transfer of assets.[56] Since the fair market value of the shares is in most cases a multiple of their nominal value, only a small fraction of a few percentage points can typically be paid to the shareholders of the acquired company in a form other than the shares of the acquiring company.

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[50] *See* Rev. Rul. 66-224, 1966-2 C.B. 114.

[51] Becker v. Commissioner, 221 F.2d. 252 (2d Cir. 1955); Bentsen v. Phinney, 199 F. Supp. 363 (S.D. Tex. 1961); Mary Archer Morris Trust, 42 T.C. 779 (1964).

[52] *See supra* note 48.

[53] *See* USA IRC § 368 (a)(1)(C).

[54] Merger Taxation Directive, *supra* note 6, art. 2.

[55] Commission of the European Communities, Proposal for a Tenth Directive of the Council based on Article 54(3)(g) of the Treaty Concerning Cross-Border Mergers of Public Limited Companies, COM(84) 727 final (Jan. 8, 1985).

[56] *See* Merger Taxation Directive, *supra* note 6, art. 2; *see also* FRA CGI Annex II § 301F. Nominal value is also known in company law as par value.

The measure in the European Union directive is in most cases just sufficient to compensate in cash shareholders who would receive fractions of a whole share from the acquiring company, thereby eliminating these fractional shares. However, in those countries where minority shareholders have a right to be bought out, the narrow limits imposed by the directive will spell trouble. Paying out a small minority holding in cash would make the merger a taxable one if the holding exceeded the small level stipulated by the directive.

Bankruptcy reorganizations pose a particular problem for continuity of interest, because the shareholders of the bankrupt company may receive few or no shares in the surviving company. Instead, it is typically the creditors who obtain shares in exchange for their debt. To facilitate this type of transaction, it can be provided that no gain or loss is recognized to a transferor company on the transfer of its assets to a new company in a bankruptcy reorganization where creditors of the transferor obtain enough stock to provide continuity of interest.[57] For this purpose, continuity of interest is determined by considering the creditors as owners of the debtor company.

3. Transfer of Liabilities

Another problem related to the continuity of the proprietary interest of shareholders is how to take account of the transfer of the liabilities of the acquired company. Part of the compensation for the assets of the acquired company takes the form of the assumption of its liabilities. To the extent of this compensation, the assets of the acquired company are not transferred in exchange for shares. However, practically all statutes will disregard the transfer of liabilities and apply the criterion of transfer for voting shares only to the net value of the transferor company. Only the transfer of the net value of the assets of the acquired company—that is, after deduction of all liabilities outstanding at the time of the merger— must be compensated for in shares. Thus, the transfer of liabilities is generally disregarded in evaluating the degree of continuity.[58]

4. Nonvoting Shares

Another problem is whether nonvoting shares qualify for the continuity test. In many countries, company law provides for various categories of nonvoting shares. Because most of these types of shares guarantee a minimal fixed return on capital and a payout of the capital value of the shares in priority to common shares, the risk in these categories of shares is much lower. Generally speaking, they are very much like long-term bonds. Therefore nonvoting shares are often not accepted as equivalent to voting shares for a tax-free reorganization.[59] When

[57] *See* USA IRC § 368(a)(1)(G).

[58] However, if liabilities exceed the value of assets and only a nominal amount of stock is transferred to the former shareholders, then the continuity of interest requirement might be considered not to be satisfied. *See* Bittker & Eustice, *supra* note 15, ¶ 14.14. In such cases, what has occurred in substance is a purchase of the assets by means of an assumption of the liabilities.

[59] *E.g.,* USA IRC § 368(a)(1)(B) (exchange of stock solely for voting stock). *But see* Bittker & Eustice, *supra* note 15, ¶ 14.11 (nonvoting shares are counted in determining continuity of interest in a merger).

this rule is applied, a practical problem may arise with some categories of shares, which may be voting or nonvoting from time to time. For example, preferred shares may normally be nonvoting as long as the preferred dividend is paid out, but may become voting when the company fails to pay out the guaranteed preferred dividend. In such a case, the common shares, which are normally voting shares, may become nonvoting. To know whether shares are voting shares, the situation should be judged as it is in fact at the time of the reorganization. If preferred shares are voting at that time, such shares should be considered as voting shares. If common shares are nonvoting at that time, they should be considered as nonvoting shares. However, when these different categories of shares are distributed, it should be taken into account that preferred shareholders may lose control and that common shareholders may gain control some time after the reorganization.[60]

5. Step Transaction Doctrine

When the conditions for a tax-free reorganization are so narrow that, in some cases, unavoidable changes in the business activity or the necessity to buy out shareholders will result in taxation of the reorganization, the question arises as to whether the parties can do after or before the reorganization what the law prohibits them from doing at the time of the reorganization. If the parties can get rid of unwanted assets by selling them or transferring them to a different company before or after the reorganization, the problems in qualifying for a tax-free reorganization are more apparent than real. The same principle applies to the redemption of minority shareholders' interests.

The U.S. reorganization rules, which are rather flexible for changes at the time of the reorganization, are generally rather inflexible before and after; that is, the same restrictions that apply at the time of the reorganization also apply before and after it. This is the result of the application of the "step transaction doctrine" in case law.[61] Under this doctrine, different transactions before and after the reorganization are considered to be "single steps" of the overall transaction if it appears that they were necessary and indispensable steps to reach a general agreement on the reorganization. Therefore, sales of assets or shares before or after the reorganization will be taken into account in determining whether the continuity requirement has been met, when it appears that these sales were implemented as part of the overall reorganization agreement.

Countries with very strict rules on continuity traditionally have not had such a step transaction doctrine.[62] This diversity of experience suggests a choice between, on the one hand, a

[60]The line cannot always be drawn very neatly. *See* Forrest Hotel Corporation v. Fly, 112 Supp. 782 (S.D. Miss. 1953).

[61]U.S. American Potash & Chemical Corporation v. U.S., 399 F.2d 194 (Ct. Cl. 1968), Commissioner v. Gordon 391 U.S. 83 (1968); Furniss v. Dawson [1984] 2 WLR 226; [1984] AC 474. Similarly, in the Netherlands, tax exemption is subject to the condition that the shares issued by the transferee company in the merger are not sold by the shareholder for three years after the merger, *see* NLD Vpb § 14(1).

[62]A typical case in point is Belgium before its tax reform of 1989. Tax-free reorganizations were an all-or-nothing affair, whereby all assets had to be transferred exclusively in exchange for voting stock. However, parties to the

formalistic system— with strict requirements for qualifying for reorganization treatment— and, on the other hand, a more flexible system policed by antiavoidance rules like the step transaction doctrine. While the latter approach can work in countries such as the United States with its sophisticated system of tax lawyers, tax administrators, and courts, it may be difficult to apply in countries whose tax system is not as developed, except by leaving considerable discretion to the tax administrators. While a formalistic system may therefore be more attractive in developing and transition countries, it also suffers from the potential disadvantage of being open to abuse. If the former choice is adopted, care should be given to defining the transactions eligible for tax-free reorganization treatment.

6. Corporate Divisions

While some countries spell out the requirements for taxfree corporate divisions in their statutes, others allow them by administrative practice, and yet others do not have provisions for taxfree divisions.[63] In some countries, all three techniques of division (spin-off, split-off, and split-up) can qualify for taxfree treatment, while in others only one or two of these can.[64]

There are often requirements concerning which assets can be contributed to a subsidiary that will be divided from the parent, but there are substantial differences in this requirement from country to country.[65] For example, in Germany, the assets of a division must be contributed together, and in the United States both the parent and the subsidiary must hold assets of an active business.

Tax law generally requires that all transferee companies carry on a business activity after a division (not necessarily the same business activity as before the division). If this condition is not imposed either by statute or by case law, it will become possible to split the corporate assets into two parts: one continuing the business and another to be liquidated. Such a transaction should be taxed as a distribution in partial liquidation, rather than as a division.

Another typical question is whether the shareholders of the transferor company need to continue their equity interest proportionally in all the transferee companies, or whether it is sufficient that they exchange their shares for voting shares of one or more of the transferee companies. This is an important question, because it determines to a great extent the flexibility of a corporate division. If all shareholders of the transferor are required to acquire the same proportional part in all the transferee companies as the part of the shares they own in the transferor, there is no flexibility at all. Often in a corporate division, some shareholders (group A) of the old company will be interested in continuing part of the business, while other shareholders (group B) will be interested in continuing some other part of the business. Therefore group A shareholders should receive shares only in company A and group B share-

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reorganization were free to dispose of shares and assets before and after the reorganization, making the restrictions at the time of the reorganization a lot less strict.

[63] *See* Rädler, *supra* note 15, at 564.

[64] *See id.* at 565.

[65] *See id*. at 568–69.

holders, shares only in company B. As long as all or the largest part of the shareholders continue their equity interest in one of the transferee companies, the reorganization should maintain its tax-exempt character.

7. Elective Taxable Treatment

Treatment of a proposed transaction as taxable or tax free is often elective in that the taxpayer can change the form of the transaction slightly to make it qualify as tax free or, if the taxpayer considers it more advantageous, to make it fail to qualify. Some countries go beyond this degree of electivity in some cases by allowing the taxpayer to elect for particular transactions whether it will be treated as taxable or as a tax-free reorganization.[66] The theory behind this approach is that it is inefficient to require the taxpayer to manipulate the corporate form of the reorganization to accomplish the particular tax result desired.

8. Requiring Approval

Although there are disadvantages in requiring approval from the tax authorities before a transaction can be engaged in (delays may impede transactions and approval requirements may be invitations for corruption), the technique of requiring a ruling from the tax authority before a reorganization can be carried out on a tax-free basis[67] does have the advantage of simplifying the drafting requirements and alleviating the concern that statutory rules allowing such transactions might be used for tax avoidance. Approval requirements might be impractical in countries experiencing a large volume of reorganizations, but might be manageable in countries where this is not the case.

C. Tax Consequences of Tax-Free Reorganizations

1. Tax Position of the Transferor Company

The tax exemption of a reorganization in itself is very simple: no tax is levied on the gain that is realized in exchange for shares.[68] When the reorganization rules allow compensation partly in shares and partly in cash and other property, the most common approach is to provide a partial exemption. This means that the gains realized in a reorganization will be tax exempt to the extent that the transfer of assets by the transferor is compensated by voting shares of the

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[66]Germany allows the transferor company an option to choose between a tax exempt and a taxable transfer; *see* UmwStG §11. This choice will of course be agreed upon between the parties to a reorganization. When the transferor company elects a tax-free reorganization, the conditions are such that the continuity of shareholders and business activity is guaranteed so that the tax liability is only deferred. In the United States, a corporation that purchases the stock of a target company may elect to treat the transaction as a taxable purchase of the assets of the target, followed by the contribution of the assets to a new corporation. *See* IRC § 338.

[67]*E.g.,* FRA CGI § 210B (requiring approval for divisions and contributions of part of a corporation's assets). *See* Bernard Chesnais and Yann de Givré, *France, in* 79b Cahiers de droit fiscal international 139, 142–43 (1994).

[68]*See* BEL CIR § 45; FRA CGI § 210 A. However the transferor company can elect taxable treatment for the transaction, in which case a concessional rate of 18 percent applies, *see* FRA CGI § 210 A - 4; USA IRC § 354 (a).

transferee, or to the extent that the shares of the acquired company are exchanged for shares in the transferee company.

For problems related to applicable tax rates and differences in tax rates between ordinary profits and capital gains and the allocation of gains to various categories of assets, we refer to the discussion of taxable reorganizations.[69] One problem that is specific to the partially taxable transaction is how the amount of the taxable profit is calculated. Basically there are two approaches. One approach is to allocate the total compensation (shares and taxable compensation) proportionally to all assets.

Examples

EXAMPLE 1

> In a merger, OLDCO receives total compensation of $20,000 reflecting its net fair market value. Of this compensation, $15,000 is paid in shares and the balance of $5,000 is paid in cash. The tax basis of the net assets of OLDCO (after deduction of all liabilities) is $6,000. Total gain on the merger realized by OLDCO is $14,000. Of this gain, one-fourth ($5,000 out of $20,000) is taxable, either as an ordinary profit or as a capital gain. The balance of the gain is tax exempt; that is, of the total gain, $3,500 is taxable and $10,500 is tax exempt.

Another approach is to subject to tax all forms of compensation other than shares, but only to the extent that the transferor company realizes an overall profit on the transaction.[70]

EXAMPLE 2

> The facts are the same as in example 1. Instead of having the total profit proportionally allocated between the compensation in shares and the other forms of compensation, the total gain will be taxed to the extent of the compensation received in a form other than shares (i.e., the total taxable profit will be $5,000).

The amount of taxable profit under the second method will always exceed the amount that is taxable under the method of proportional allocation.

Although most countries will tax the transferor company in a merger to the extent that the transfer of assets is not compensated for in voting shares, some tax systems do not tax the transferor company when, or to the extent that, the nonshare compensation is distributed by that company to its shareholders pursuant to the plan of reorganization. Only the shareholders of the transferor company will be taxed if, and to the extent that, they receive compensation other than voting shares. The basic reason for this approach is that the transferor company is acting only as a conduit to transfer the compensation received in the reorganization to its shareholders, while

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[69] *See supra* sec. III.

[70] *E.g.,* USA IRC § 356.

the transferor itself does not realize a profit and should not be taxed on the compensation transferred to the shareholders.[71] It should be noted, however, that such look-through treatment of the transferor company is inconsistent with the classical system involving double taxation of companies and shareholders.[72]

This rule can be accepted only when it is certain that all shareholders will be taxed on any profits. When individual shareholders are not taxed on their capital gains, this rule should not be applied. In such cases the only place to tax the nonshare compensation is the transferor company.

2. Tax Position of Transferor Shareholders

The same rule should apply to the transferor company and to its shareholders: to the extent that the reorganization is compensated for with voting shares, the gain realized by the shareholders of the transferor should be tax exempt.[73] In many countries, however, gains realized by individual nonbusiness shareholders, nonprofit organizations, or tax-exempt institutions such as pension funds are tax exempt in any case. In these tax systems, it is not necessary to provide a specific exemption for these types of shareholders.

A special case of exemption is the gains realized by holding companies. In some countries, capital gains realized on shares by holding companies are fully tax exempt in order to eliminate double taxation.[74] It follows that even when there is a fully or partially taxable reorganization, the gains realized by a company that is a shareholder in the transferor or acquired company are always tax exempt, even when the latter company is fully or partially taxed on the reorganization.

For business taxpayers, the exchange of shares for consideration other than voting shares should always be a taxable event even within the framework of a "tax-free" reorganization. The reason is that it is easier to partially tax the consideration that has taken a form other than voting shares than it is to transfer the old cost base of the shares surrendered to the assets received. Particularly when the compensation is in cash, it would be awkward to have cash booked with a cost base equal to the value of the old shares surrendered. However, to the extent that

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[71]*See* GBR TCGA § 139(1) (applies where the transferor "receives no part of the consideration for the transfer"); USA IRC § 361(b).

[72]This is not to say that the United States has always exhibited great consistency in its approach to the classical system. Up to 1986, corporations could (under the so-called *General Utilities* doctrine) distribute appreciated property to shareholders without incurring tax on the gain, thereby eliminating economic double taxation on these gains. With such inconsistent treatment in the background, it is easy to understand that the merger rule is not always consistent.—L.M.

[73]*See* FRA CGI §§ 92B, 92J (shares listed on the stock exchange), 160 I *ter* (shares constituting a holding exceeding 25 percent of outstanding capital), 150 A *bis* (shares in real estate companies); DEU UmwStG § 13; GBR TCGA § 135; USA IRC §§ 354(a), 356.

[74]*See supra* note 28.

compensation is not in cash, it should be possible to exempt the transfer and to defer the tax liability by continuing the cost base of the old assets for the new assets received in exchange.[75]

The taxable profit will be calculated as the difference between the total compensation received and the cost base of the shares surrendered.[76] The alternatives for calculating the amount of profit are the same as those discussed above in connection with taxing the transferor in a partially taxable reorganization. Either the total profit will be proportionally allocated over total compensation in shares and other forms of compensation, or total nonshare compensation will be taxed to the extent that there is an overall profit on the transfer of shares.[77]

Finally, there is the problem of eliminating double taxation between companies and shareholders. As already indicated,[78] this problem has been solved in Belgium and the Netherlands. In other countries, it has not been solved for the simple reason that it is not perceived as a problem. Gain on the exchange of shares in a reorganization is conceptually qualified as a capital gain, which is a category separate from dividends. Therefore, in most countries the concept of double taxation of companies and shareholders is simply not applied to this situation.[79] However, in some countries the gain is considered as a liquidating distribution by the transferor at the time of the reorganization. The liquidating distribution is sometimes considered as the equivalent of a dividend, thereby raising the question of relief for double taxation. The shareholders of the transferor company may therefore receive a tax credit or an exemption for dividends received as in an ordinary distribution of a dividend. The problem with these solutions is that in most cases the tax credits or the amount of the exemption for dividends received for the transferor company and its shareholders do not match because, as stated, the gains of the transferor company and its shareholders do not match either. As a consequence, the elimination of double taxation between the transferor company and its shareholders in a partially tax-free reorganization is far from perfect.

The position of the shareholders of the transferor company after the merger is subject to the continuity principle, implying that: (a) to the extent that the exchange of shares is free of tax, all the tax attributes of the shares in the transferor company will be carried over to the shares in the transferee company as if the reorganization had not taken place; and (b) to the extent that the exchange of shares has been taxed, the tax basis of the shares in the transferee company will be revalued and all tax attributes of the shares in the transferor company will disappear.

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[75]USA IRC § 358(a) provides an adjustment of the tax basis when property is received in exchange for consideration other than stock or securities.

[76]FRA CGI §§ 150 A *bis,* 160 I *ter* defer the tax liability until the shares received in exchange are sold.

[77]*See supra* sec. IV(C)(1).

[78]*See supra* note 28.

[79]Note, however, the intricate Norwegian "RISK" rules, which allow a step-up of capital gains tax basis for shares with respect to retained, taxed profits, with the purpose of eliminating economic double taxation not just for distributed profits, but for profits the shareholders realize as capital gains.—L.M.

3. Tax Position of the Transferee Company

The transferee company is not taxed in a merger unless it is at the same time a shareholder of the transferor company. This special case will not be discussed here. In a reorganization, the transferee company is mainly interested in what happens after the reorganization. The position of the transferee company is determined by two elements: (a) the tax basis of the assets received from the transferor, and (b) the carryover of other tax attributes of the transferor.

A. TAX BASIS OF THE ASSETS TRANSFERRED

The rules for determining the tax basis to the transferee company after the merger are roughly the same as the rules for determining the tax basis of the new shares on behalf of the shareholders of the transferor company. To the extent that the transfer of assets is taxed to the transferor company there will be a revaluation of these assets for tax purposes; to the extent that the transfer of assets has been tax free, the transferee company will carry over the tax basis that those assets had before the reorganization in the transferor company.[80]

The problems of allocating the amount of taxable profit to various categories of assets (inventory, fixed assets, goodwill) have been discussed in connection with taxable transactions.[81] These problems are exactly the same in a partially tax free merger. To the extent of the amount taxed, the increase in tax basis has to be allocated over several categories of assets. The valuation of the assets in the reorganization will be decisive in allocating the amount of profit realized by the transferor. When the reorganization is completely tax free, there is no problem of allocation, because the existing tax basis of the assets of the transferor company is carried over.

B. DISPARITY BETWEEN TAX ACCOUNTING AND COMMERCIAL ACCOUNTING

The carryover of the old tax basis of the assets of the transferor company in a tax-free reorganization may result in a disparity between tax accounting and commercial accounting, depending on the accounting rules in the tax jurisdiction. Basically, a reorganization can be accounted for by either pooling accounting or purchase accounting.

Pooling accounting consists in carrying forward without any change all book items of the transferor company as they existed before the reorganization. It is the accounting method that is recommended for tax-free reorganizations in the United States, because the accounting rules coincide with the tax rules.

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[80]*E.g.,* BEL CIR § 212; USA IRC § 362(b). In France, a distinction is made between depreciable and nondepreciable assets. For nondepreciable assets such as land and securities, there is a single carryover of the old tax basis; *see* FRA CGI § 40, 151 *octies*. For depreciable assets, the capital gain that has been exempted must be reintegrated in taxable profits over a period of 15 years after the merger; *see* CGI § 210A(3)(d). The argument has been made that in the context of privatized enterprises in transition economies, it may not make much sense to provide for basis carryover, because the basis may bear no relation to reality. The alternative would be to allow such enterprises a fresh start valuation at market value without requiring recognition of gain. *See* Kodrzicki and Zolt, *supra* note 5, at 629–33.

[81]*See supra* sec. III.

Purchase accounting treats the transfer of assets in a tax-free reorganization as a sale and results in the revaluation of all assets transferred from the transferor company on the basis of their fair market value. The use of purchase accounting in a tax-free reorganization results in a discrepancy between commercial accounting and tax accounting after the reorganization in respect of the transferee company.

Example

A building that has been completely depreciated is transferred in a tax-free merger. The tax basis of the building is 0. In the merger, the building is valued at $1,000,000. When purchase accounting is used in the merger, the building will be recorded in the accounts of the acquiring company at $1,000,000, and depreciation will be calculated on $1,000,000. For tax purposes, however, the building will be transferred tax free to the acquiring company at a value of 0, and no depreciation will be allowed; hence, a discrepancy arises between depreciation for commercial accounts and depreciation for tax accounts after the merger.

Countries that base tax accounting on commercial accounting will have to use pooling accounting for tax-free reorganizations.[82]

C. CARRYOVER OF TAX CHARACTERISTICS FROM TRANSFEROR TO TRANSFEREE

When a corporation disappears in a merger or its assets are acquired, the question arises as to whether various tax attributes of the corporation are carried over to the transferee. In a formalistic approach, these attributes would disappear, because they are personal to the taxpayer, but the tax laws typically stipulate that they are carried over in a tax-free reorganization, subject to limitations.[83] One difficulty is that there are a number of potential tax attributes whose treatment is not necessarily consistent (in particular, as discussed below, limitations are often placed on the carryover of net operating losses).

The position of the transferee company on the carryover of tax characteristics of the transferor company in general can best be illustrated by the carryover of losses, methods of depreciation, and inventory valuation.

Practically all developed tax systems limit the transfer of loss carryovers from one company to another in tax-free reorganizations.[84] In some systems, loss carryovers are simply

[82] *E.g.,* DEU UmwStG §§ 4, 12.

[83] *E.g.,* USA IRC § 381; Bittker & Eustice, *supra* note 15, ¶ 16.01.

[84] France requires a preliminary ruling (*agrément préalable*) to carry over tax losses in a corporate reorganization; *see* CGI § 209 II. In Germany, loss carryovers from the company that disappears in a merger are prohibited on the principle that the transferor and the transferee company are two different taxpayers and that losses from one taxpayer cannot be carried over to another taxpayer. Tax practice has applied a self-help method, however, by having the loss company act as the transferee company so that tax losses can be preserved within the entity of the same taxpayer. *See* Brigitte Knobbe-Keuk, Bilanz- und Unternehmenssteuerrecht 598 (1993).

prohibited. However, most tax systems apply one of two alternative approaches or, in some cases, may apply both approaches simultaneously.

The first approach is a variation on the substance-over-form approach or the requirement of a specific business purpose for the tax-free reorganization. It is mostly applied by case law or by rulings because it requires some qualitative evaluation of facts. The loss carryover will be permitted only when there is some economic substance to the merger that justifies the compensation of losses from one line of business with profits in another line of business. This approach sometimes leads to surprising results and causes uncertainty for taxpayers. In some cases, tax law allows a tax loss carryover only if there is a business purpose.[85] A variation of this approach requires continuity of business activity.[86]

The second approach is a strict statutory and quantitative approach. The tax law states some hard and fast rules that are based on quantitative restrictions that always apply, even when loss compensation in the tax-free reorganization would be justified on good business grounds.[87] Basically, there are two ways to apply this approach: one is a continuity-of-shareholders test and the other is a comparison-of-assets test.

The continuity-of-shareholders test was used in the United States before the Tax Reform Act of 1986. The rule called for tax loss carryovers to be reduced in proportional amounts when the shareholders of the transferor company did not acquire a certain minimum threshold participation in the transferee company. For example, full loss carryover was permitted only when the shareholders of the loss company obtained at least a 20 percent share participation in the profitable company. For each full percentage point by which the shareholders of the loss company fell short of the 20 percent target, the amount of the loss carryover was reduced by 5 percent. For example, when the shareholders of the loss company acquired only 5 percent of the interest in the profitable company, only 25 percent of the amount of the tax losses could be carried forward.[88]

Another approach is the relative comparison-of-assets test. Losses can be carried forward only to the extent of the percentage share that the assets of the loss company represent in the total assets of the combined company or companies after the reorganization. For example, if the net value of the loss company represents only 5 percent of the total value of the combined companies, only 5 percent of the loss may be carried over.[89]

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[85]Libson Shops v. Koehler, 353 U.S. 382 (1957); Maxwell Hardware Co. v. Commissioner, 343 F.2d. 713 (9th Cir. 1965).

[86]*E.g.,* DEU KStG § 8(4) (denying tax loss carryovers when more than 75 percent of the shares have been transferred and the acquired company has substantially changed its business). This rule puts severe restrictions on the rule that permits the transferee company to carry forward tax losses in a tax-free reorganization.

[87]In the Netherlands, there is no tax exemption for an asset acquisition when one of the participating companies has a tax loss carryover (combination of Vpb §§ 14 and 20); *see also* DEU KStG § 8(4).

[88]*See* USA IRC § 382 (1986); *see also* AUS ITAA (1936) § 80 DA(A)(d); GBR ICTA § 768 (a major change in ownership and a major change in the nature or conduct of a trade).

[89]*See* BEL CIR § 206(2).

The United States currently uses a more sophisticated version of this approach, under which the loss carryover is limited to the value of the loss company's shares multiplied by a long-term interest rate.[90] This approach allows the losses to be offset against a notional return on the assets of the loss company.

In a corporate division, loss carryovers should follow the transfer of business activity. That is, when a business is divided in such a way that company A continues the basic business activity, while another company B receives assets and liabilities but carries on a completely new business activity, losses should be transferred exclusively to company A. A net asset test for the division of loss carryovers may result in distortions, because liabilities of the transferor company may be dumped exclusively in the transferee company carrying on the nonprofitable business, thereby reducing its net fair market value almost to zero.

Tax credits should also follow the business activity. To the extent that such credits are related to particular assets, specific investment requirements (e.g., oil exploration), or specific activities (research and development), the credits should follow either the assets or the specific activity to which they are linked.

Another issue is the carryover of depreciation methods, methods of inventory valuation, and other methods of accounting.[91] The basic rule is that the methods of accounting used by the transferor must be continued by the transferee after a tax-free reorganization. However, sometimes the taxpayer is allowed to change these methods when there are good business reasons for such a change. Some, but not all tax systems also accept a business reorganization as an occasion that justifies such a change, in order to apply the same methods of accounting in the combined company or companies after the reorganization. Such changes may go in both directions. The assets of the transferor company can be valued and depreciated in accordance with practices used before the reorganization by the transferee company, or all assets after the reorganization may be valued or depreciated in accordance with practices formerly used only by the transferor company. In this sense, there may be discontinuity in depreciation practices and valuation practices even after a tax-free reorganization.

Finally there are the rights of the taxpayer in matters of tax procedure, such as appeals, collection, and litigation. The carryover of all rights and obligations in tax procedures is not so much determined by tax law, which seldom provides that these procedures will be carried forward by the transferee company or that the transferee company will be considered as the general tax successor to the transferor company. The rule imposing a carryover of all procedural aspects of taxation is most often situated in company law or, in some cases, in the code of civil procedure.[92]

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[90]*See* USA IRC § 382.

[91]*See supra* sec. III(C); USA IRC § 381.

[92]*See also supra* sec. III(C).

In corporate divisions, one way to solve the problem is to make all transferee companies jointly liable for tax obligations, which means that they can also act jointly in tax protests and tax litigation after a corporate division. In practice, collection of tax liabilities should always follow the business activity of the transferee companies. The other transferee companies should be liable only when the tax liability cannot be collected from the transferee company to which it belongs. If a tax liability is specifically linked to a particular asset (e.g., land tax on real estate), the tax liability and ensuing tax protests and tax procedures may appropriately follow the asset.

V. Taxes Other Than Income Tax

The tax consequences of corporate reorganizations are not limited to income tax. There are always the problems of carrying over the tax characteristics of any tax from transferor to transferee company and from old to new shares. For two types of taxes, the problems are more pressing than for others because they raise problems of tax exemption: taxes on capital contributions and value-added tax.

Many countries levy taxes on equity contributions to capital or stamp duties on transfers of assets.[93] A corporate reorganization often requires a formal capital contribution, which in some cases may impose a considerable tax burden (e.g., if a newly formed subsidiary is involved). The reasons for exempting reorganizations from tax on capital contribution or stamp taxes are largely the same as the reasons for exemption from income tax. The basic difference between the exemption from these taxes and the exemption from income tax is that the former is final, whereas the latter is temporary. The simplest way to deal with this exemption is to impose the same conditions for exemption as in the income tax.

Finally there is the problem of value-added tax or sales tax.[94] Here too, there is a case for temporary exemption, as long as the transferee who carries on the business also remains responsible for all tax obligations. It will not be appropriate, however, to impose the same conditions for exemption as in the income tax, for the simple reason that the tax fate of the shareholders of the transferor company is irrelevant to the sales tax or value-added tax. Only the transferor and the transferee company are involved as taxpayers. Therefore, the only requirements that should be imposed are (1) that the business activity should be transferred to and continued by the transferee (transfer of all or substantially all assets and liabilities),[95] and (2) that the transferee should be subject to sales tax or value-added tax with the same rights and obligations as the transferor. The type of consideration paid in the reorganization is irrelevant (therefore, sales of a business should qualify for exemption). The type of taxpayer is also irrelevant, so that it should be possible to have a transfer free of value-added tax between a corporation and an individual and vice versa as long as both parties are taxpayers under the value-added tax. The same approach can be applied in the case of the excise tax.

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[93]Exemptions from these taxes in reorganizations are discussed in Tomsett et al., *supra* note 45.

[94]*See* vol. 1, at 216–17.

[95]In contrast to the requirements for tax-free reorganizations under the income tax, here, substantially all the assets means the assets of a business, not all the assets of the transferor (which may have several businesses).