THE POSITIVE ROLE OF TAX LAW IN CORPORATE AND CAPITAL MARKETS*

Saul Levmore

Discussion Paper No. 27

4/87

Program in Law and Economics
Harvard Law School
Cambridge, MA 02138

The Program in Law and Economics is supported by a grant from the John M. Olin Foundation.

*This paper was presented at the Conference on the Economics of Corporate and Capital Markets Law held at Harvard Law School in November 1986. The conference was sponsored by the Program in Law and Economics.

I. Intrusions of Tax Law Into Corporate Law

Taxes are normally and correctly viewed as unfortunate and annoying intruders in the elegant world of capital markets and in the already complicated world of corporate law. No less than eleven different types of intrusions are easy to recognize. By focusing on "recognition" events rather than on periodic appraisals of wealth, and by not completely excusing or deferring tax on gains from the sale of stock and other capital assets, tax law discourages exchanges[1]. Taxes, like brokers' commissions, add to transaction costs and therefore discourage transactions.[2] Second, by taxing cash dividends, by taxing such dividends more harshly than income realized from the sale of stock, and by taxing such dividends less harshly when they are of the intercorporate variety, tax law may affect the dividend policy of a firm.[3] To the extent that a firm's dividend policy is affected, its overall reinvestment policy is likely also to be affected.[4] Third, the compensation packages offered to managers and other agents of the firm are likely to be influenced by tax laws. Recipients may prefer deferred compensation, certain fringe benefits, and only particular kinds of profit-sharing plans, and may make it worthwhile for the firm to structure compensation in ways that differ from how things would be done if taxes did not depend on the form of compensation. Put in terms of the literature on agency costs, a certain compensation package offered to agents may minimize the monitoring costs of the shareholders and creditors of a firm, but tax law may then encourage the use of a different package that brings on higher agency costs (even as it encourages stock options, for example which may decrease agency costs).[5] Fourth, although in the absence of taxes there may or may not be an optimal means of financing the firm, tax laws, such as those that make interest but not dividend payments deductible, may make some capital structures suddenly appear more attractive than others.[6] Fifth, the treatment of financial intermediaries, such as banks and stock and mutual insurance companies is sufficiently uneven as to suggest that the existing mix of these intermediaries is strongly influenced by tax considerations rather than by organizational qualities alone.[7] Sixth, since inputs like labor and property are often separately and differently taxed, it is likely that the mix of inputs that is utilized in a given enterprise is different from that which is most efficient in productivity terms alone.[8] Inputs aside, the very size of an enterprise is likely to be influenced by taxes (in addition to organizational and scale considerations). For example, the inability of firms that have experienced losses to transfer all their losses to profitable firms, while multidivision enterprises are of course able to offset gains and losses and pay taxes based on their net gains[9], and the different treatment accorded earnings distributed as dividends from those retained in a corporation,[10] distort things in favor of larger enterprises. Somewhat similarly, the treatment of business losses and the somewhat progressive character of tax rates may discourage risky investments even when their expected values exceed those of investments with less variance in possible outcomes.[11] Ninth (for those who are counting), tax laws may encourage a mix of forms of ownership that is different from that which would prevail as a result of agency cost and other real, or non-tax considerations. I have in mind tax rules such as those that encourage (or discourage) leasing and those that deny certain treatments when there are more than some specified number of shareholders.[12] Indeed, such an important ownership change as a leveraged buyout may largely be motivated by tax considerations. The large premiums enjoyed by those who sell out in these buyouts may be little more than their shares of the tax savings.[13] Most simply, capital may be deployed in various geographic locations in spite of inferior resources, labor, and transportation, because relatively low taxes are associated with these locations. Finally, at the end of this long list, tax laws intrude upon the allocation of resources among industries. The various exclusions, depreciation schedules, and accounting rules that are the soft underbelly of the tax system yield different marginal and average tax rates -- and therefore surely different incentives to invest -- in different types of enterprises.[14] To the extent that such differentials reflect acccidental political arrangements rather than sensible social policies regarding externalities, public goods, and the like, resources are surely misallocated. Unfortunately, the tax system itself makes it difficult for us to assess these differentials because taxes are imposed not only on the firm but also on the receipts of shareholders and bondholders. Inasmuch as these payments to investors may <u>themselves</u> play roles in the efficient allocation of resources, it is necessary to compare all the taxes associated with various enterprises and industries before concluding that apparent differentials inefficiently bias investment.

The length and relentless quality of this list suggest that intrusions under the tax laws are at least partly understood and tolerated. This tolerance is, I believe, the product of a political and an economic reality. As a political matter, those who draft and enforce our tax laws are most concerned with the ability and ingenuity of taxpayers to avoid taxes. From this perspective, the efficiency cost of a tax is welcome because it usually forms a constraint on tax avoidance. For example, since there are organizational or efficiency reasons to offer employees' certain compensation packages, employers will not use those packages that minimize taxes. Similarly, since there are real efficiencies in conducting business in given forms, size, and locations, taxpayers will often fail to take advantage of all avoidance strategies, including transformations of form and relocations, because there are real costs to such strategies. A less ambitious way to put this point is as follows: Lawmakers are wary of taxpayers' avoiding all forms of taxation and, therefore, when a tax appears to distort economic behavior on the margin, these lawmakers might focus less on the inefficiencies generated by a particular tax than on the inframargin where taxpayers are sufficiently locked in and unable to escape the tax.

The economic explanation of why so many intrusions of tax law in the functioning of the capital (and other) markets are tolerated, begins with the observation that every major tax in our collective arsenal is itself intrusive; our property taxes distort the use of inputs, our income taxes reduce the incentive to earn, and so forth. Given the government's need to raise large amounts of money for public goods, including national defense and debt repayment, it may well be that every method of raising revenues is intrusive in some market or other and that these intrusions are progressively more serious as additional revenue is sought through any one method. Intrusions of the kind sketched earlier may therefore be tolerated because alternatives are thought to entail other or more serious inefficiencies.

This last explanation may seem less abstract if a familiar example from the current scene is reviewed. A tax on the sale of exchange of capital assets, or any assets for that matter, is intrusive in the familiar sense that taxpayers may hold on to such assets longer than they would if exchanges did not trigger taxation. It might, therefore, seem efficiency-enhancing to repeal this tax or to tax appreciation periodically regardless of whether there has been an exchange. Assuming away the latter possibility for reasons related to political reality or administrative costs, and assuming an unrelenting demand for the revenues currently raised from the taxation of capital gains, it is quite clear that doing away with the taxation of gain on the sale of stock or real estate, for instance, would require an increase in the tax rates applicable to other (less favored) income. In turn, these higher rates may discourage work (as opposed to leisure) and encourage efforts to avoid tax or to engage in tax favored, but unproductive, activities.

This familiar illustration and the more general arguments, or explanations, of why we tolerate so many intrusions by our tax laws, which preceded it are intended to emphasize the argument up to this point: Our tax system contains numerous moderate intrusions and it may be unrealistic to expect that it could be otherwise.

In spite of the preceding sketches and arguments regarding the seemingly endless set of intrusions by tax law into corporate and capital markets, the goal of this paper is in an opposite direction and depends not at all on agreement about the magnitudes of various intrusions. I aim to show ways in which tax law complements or supports, rather than intrudes upon, the efficient functioning of markets. These illustrations are meant not only to be revealing and interesting on their own but also to suggest that there are important interactions between tax law and agency cost (and other efficiency) considerations. It may be possible to study some industries and markets while paying little attention to tax laws, but it is not possible, I think, to separate an understanding of the market for corporate control, for example, from an understanding of the taxes levied on assets and transactions in that market.

In exploring the "positive interactions" between tax law and corporate law, I do not mean to imply that the various intrusions are somehow less important then the positive interactions. These intrusions have long been the focus of the tax policy literature for reason. On the other hand, some of the interactions between tax law and corporate law are quite subtle and their exploration requires a fair amount of familiarity with and sensitivity to the world of corporate law rather than the world of public finance that is the normal background for academics who write about tax policy.

Put somewhat differently, although I take seriously the goal that I have set out in this paper, of arguing that there are subtle, positive roles played by taxes, I have a broader aim as well. Tax law, and especially corporate tax law, is too often seen as something to be assumed away or left to the specialists who examine legislative histories and drive trucks through seemingly small loopholes. My aim is to tempt those who think about the corporate and capital markets to study and think about tax law as well, for these subjects regularly overlap. The specific areas of ineraction that I have chosen to explore in this paper concern, first, the ways in which tax law influences the mix of debt and equity financing of the corporate firm, and, second, the way in which certain kinds of stock acquisitions are treated. The detail and complexity of these examples suggest that tax law, at least in part, must become the province of those who think carefully about corporate law.

II. The Positive Influence of Tax Law on the Capital Structure of Firms.

As already noted, taxes may interfere with the central message of Modigliani-Miller's irrelevance proposition. This intrusion will be most certain if a significant number of tax-exempt or low-taxed investors, such as pension funds, businesses that lend money to pension funds, and charitable foundations, can invest in corporate debt; since interest payments on such debt are deductible to the issuing corporation while dividend payments are not, high debt-equity ratios may come about.[15] The existence of these abnormal investors, or creditors, is an important part of the story because otherwise the deductibility of interest payments by firms with high debt-equity ratios may be no more advantageous than the deductibility of interest payments by individuals who, in accordance with the classic story of homemade leverage, borrow money in order to buy stock in firms with low debt-equity ratios. When there are many tax-exempt investors, however, it is easy to see that there will be a good deal of debt at the firm rather than at the individual level, for firms will obviously prefer to purchase financing that is a deductible expense.

If everything else about capital structure were truly irrelevant, none of this would be terribly troubling. Firms would simply have high debt-equity ratios but, as a normative matter, no combinations of debt and equity would be better or worse than others. An argument against excessive debt (for instance) must incorporate an assumption or rely on a set of facts that is contrary to the assumptions of the irrelevance proposition. Thus, one could assert that bankruptcy generates great private and social costs and argue that large amounts of debt are a bad thing because the probability of bankruptcy (and unanticipated displacements) increases. In turn, one can then argue that debt can and should be discouraged either by requiring tax-exempt institutions to pay tax on the receipt of interest income or by denying interest deductions to issuers to the extent that creditors pay no tax on their receipts of interest payments.[16] I prefer, however, to construct this argument around agency costs instead of bankruptcy costs, if only because the expected value of the latter may be small.[17] It is arguable that there _is_ an optimal capital structure for each firm because some combinations of secured debt, unsecured debt, and equity (and even preferred stock and convertible securities) generate lower agency costs than do other combinations. There is little point in reviewing the literature regarding these matters; suffice to say that for a given firm some capital structures may better reduce monitoring and bondings costs than others--perhaps by encouraging some creditors to monitor the firm and by giving a firm's managers a great incentive to maximize profits without encouraging so much risk-taking that the cost of borrowed capital becomes excessively great[18]--and that tax laws may inefficiently intrude on financing decisions as discussed earlier. Again, the solution may be to require the issuer to withhold taxes unless the recipient pays tax on interest payments.

Let us move away from this intrusion, or "negative" effect of taxes on financial policy, and consider the following set of tax laws that may have a "positive" effect. Section 351 of the Internal Revenue Code allows those who pool capital and form a corporation to receive stock and securities, including bonds (that are not very short in term), in return for the property they contribute without recognizing gain on the transaction. If, for instance, A, B, and C contribute cash, appreciated real estate, and appreciated stock (in some other company, X) to a corporation in return for its stock and bonds, then neither the corporation nor A, B, and C recognizes any gain. All tax is deferred; C, for example, will take as a "basis" in the stock and securities he receives the basis he had in his appreciated shares of X Corporation. On the other hand, section 351 does not apply to a situation in which an ongoing firm distributes bonds to its shareholders. To the extent that these bonds are received in non-pro-rata fashion, they (or the difference between their value and the basis of anything given up) will be treated as exchanged and subject to gain recogntion if they are distributed in pro-rata fashion, then they will be treated under section 301 as dividends.[19] The tax treatment of such bonds is often explained as differing from that of stock dividends (which can be received from an ongoing corporation in pro-rata fashion without the triggering of a tax) because a given corporation's bonds are more liquid than its stock; bonds, like cash, are thus taxed on receipt. This explanation only highlights the remarkable difference between bonds distributed at the time of formation,[20] when 351 governs, and those distributed by an ongoing firm, when 301 provides the rule. The difference, again, is extreme: bonds seem quite favored at formation but are as disfavored as cash afterwards.[21]

In Modigliani-Miller (or "irrelevance" or "invariance") terms these rules seem quite senseless.[22] Given that shareholders can borrow on their own, purchase stock in the firm, and thus create on their own whatever risk-and-return combination they would wish the firm to arrange, it seems odd or intrusive for the tax laws to penalize leveraging by the ongoing firm. Individuals do not recognize gain when they borrow on their own;

indeed they do not even recognize gain when they borrow on the strength of assets that have appreciated in their hands without being taxed.[23] Put somewhat differently, an individual who contemplates joining in with a group that is forming a new corporation cares very little about the capital structure of the new corporation (assuming that his role in controlling the firm is not at issue or is not much affected by the firm's capital structure). If it chooses a high debt-equity ratio and appears too risky for his portfolio and taxes, he can buy fewer shares and become a creditor; if the opposite is true, he can borrow and buy more shares. Assuming either that the individual and corporate tax rates are roughly equal and that both investor and the firm can fully use their interest deductions[24] or that the market price of the debt reflects any tax advantages and handicaps,[25] the initial capital structure is irrelevant to each investor. Section 351 at the corporate level simply mirrors the treatment of borrowing at the homemade, or individual, level; just as an investor can use appreciated property as collateral and borrow money without recognizing any gain, so too he can contribute such assets to a corporation and let it issue debt without any gain recognition.

By way of comparison, a shareowner of an ongoing firm can also always manipulate his risk-and-return by lending or borrowing on his own, but he is <u>not</u> indifferent to the firm's maneuvers. If the ongoing firm distributes bonds, the shareholder will have income to report (because Section 301 and not 351 governs the transaction) whereas, if the firm is passive and the shareholder borrows in order to buy more shares (and thus fashion the risk-and-return package (with his own shares as collateral perhaps) that would have been formed by the firm's issuing of bonds), there is no tax liability.

This difference may seem at first to be indicative of yet another intrusion of tax law into the smooth functioning of corporate and capital markets. But a more pragmatic perspective yields, I think, just the opposite conclusion. The practical message of the irrelevance proposition for corporate managers is, after all, that time and energy are best spent on real rather than financial variables; managers should try to lower real production costs and increase outputs because effort spent on determining and achieving the "optimal capital structure" is wasted. Arguably, the 351-301 distinction reinforces this message: managers are somewhat discouraged from fiddling with the capital structure of an ongoing corporation by the law's decision to require the recognition of gain on the receipt of bonds. The law thus can be described as adopting a Modigliani-Miller perspective and as encouraging managers to focus on real rather than financial variables.

The positive effect of tax law in this setting can be put even more strongly. One can view the Code as recognizing that excessive debt (compared to agency cost considerations alone) will be encouraged by the combined presence of tax-exempt investors and the interest deduction. The task, in support of efficient corporate and capital markets (in agency cost, or real, terms), is then to discourage debt--and the rules governing midstream distributions of debt, whether in redemption, reorganization, or dividend distribution, do just that by refusing nonrecognition treatment.[26] The tax laws governing exchanges involving debt can thus be seen as both discouraging excessive debt and discouraging managers from irrelevant or even destructive "financial fiddling" with the capital structure of the ongoing corporation.

The obvious objection to this proposition is as follows: Why not also discourage financial fiddling and excessive debt at the time a corporation is formed? Why not regard bonds as the equivalent of cash even at the time of incorporation? Three lines of response suggest themselves. First, debt is an important currency in pooling arrangements because someone who contributes more capital than his coventurers may conveniently be given debt both so as to give maximum incentive in the form of equity shares to other parties and in order to eliminate the financier's fear that his conventurers will hope for a quick dissolution and capture of his contribution.[27] Debt is thus more important at the time of a firm's formation than later on. Second, the irrelevance proposition suggests that there may be an optimal capital structure for a firm at the time of its formation. Some firms may (with a high debt-equity ratio) wish to appeal to low-taxed investors and others may raise capital most inexpensively by appealing to high-bracket investors who will prefer retained earnings (and deferred gains) to interest income.[28] Indeed, many investors will hope that a firm announces or displays its capital structure and then <u>not change</u> this structure. Investors can choose investments according to their individual tax and portfolio circumstances (and, if they like, engage in homemade leverage or unleverage if they wish to adjust the risk-and-return qualities of their investments), but they must continue to readjust (or hold a suboptimal portfolio) if the firms they have invested in alter their capital structures. Again, the taxing of debt that is distributed to shareholders discourages such alterations at least in the sense that the tax disadvantage is so obvious that it will be difficult for managers to explain the distribution of debt as in everyone's interest.[29] Finally, it seems sensible to combine this last point with an agency cost analysis. Fiddling with the capital structure may reduce agency costs, but fiddling with an ongoing firm's capital stucture may upset expectations (about risk-and-return and about tax considerations) more than it improves agency arrangements (even though these may change somewhat over time).

In short, the relatively harsh treatment surrounding the receipt of debt from ongoing corporations can be explained as partially offsetting the tendency to excessive debt (discussed earlier) and as discouraging financial fiddling in the face of both the irrelevance proposition and settled investor expectations. In contrast, the relatively friendly treatment surrounding the receipt of debt by those involved in the formation of corporations can be viewed as in harmony both with the notion that some amount of debt is optimal for agency cost reasons and with the need for debt in pooling arrangements among conventurers who will supply different proportions of capital and labor.

The treatment of preferred stock supports rather nicely the idea that there is a positive link between the law and Modigliani-Miller's irrelevance proposition. Section 351 protects the issue of preferred stock as it does bonds. Sections 305 and 306, however, provide more generous rules for the distribution of preferred stock by an ongoing corporation than are available for the distribution of bonds. Suffice to say that preferred stock can, like pure stock dividends, be received (even in pro-rata fashion) without the recognition of gain. Taxes are collected only when such stock is sold. The rules are a bit complicated, for these taxes attempt to make up for the earlier (tax-free) receipt of what now looks like a dividend, but the complexity need not concern us here.[30] It is sufficient to note that preferred stock is treated more kindly than debt; tax law makes each attractive at formation but has less patience for bonds than for preferred stock distributed by the ongoing corporation.[31] The usual explanation for these treatments is, as a positive matter, adequate; Congress is said to have recognized that preferred stock can be a useful tool in providing for intergenerational succession in business ownership while bonds, although certainly as useful in this regard, are just too liquid (too much like cash) to permit their tax-free or tax-deferred distribution.[32]

The treatment of preferred stock is doubly explicable if one also thinks in terms of the irrelevance proposition. Homemade leverage is possible because an investor can borrow and take a stronger equity position in a firm, but "homemade preferred stock" is not so easily manufactured. If an investor wishes that a firm had more preferred stock in its capital structure--assuming that preferred stock plays some role in the construction of an optimal portfolio[33]--there is little that he can do, for he can not normally find a third party who will advance funds to him with conditions that resemble those attached to preferred stock.[34] In short, since homemade preferred stock is much less easily created than homemade debt, tax law can be viewed as making it easier for a firm to distribute preferred stock (rather than debt) to its shareholders.

Perhaps the most forceful objection to this claim that the tax laws concerning the receipt of bonds and preferred stock by common stockholders work in tandem with, rather than intrude upon, efficient capital markets is that a firm can always fiddle with its capital structure by issuing more common stock (for value) or by redeeming stock. Moreover, since there is no tax disadvantage either to distributing bonds (to existing shareholders or other investors) for fair value or to paying off debt, the firm has many ways to engage in financial fiddling and only some--involving the distribution of debt by an ongoing corporation to its shareholders for less than full value--are discouraged by the tax laws. One must, however, consider the constraints under which tax jurisprudence operates. The goal is to tax income, more or less, and it would be inconceivable to do anything but give credit for the value given up by an investor in return for bonds or other debt.[35] To be sure, a tax could be imposed at the firm level and borrowing could be made a taxable event (as a proxy for the unrecognized tax on appreciated assets). But which borrowers should be taxed? If all are taxed, including firms at the time of their formation, then tax law will intrude on attempts to minimize agency costs through careful arrangement of capital structures. Debt will be discouraged even though there is no reason to think, in agency cost or other terms, that it is efficient to discourage debt and encourage equity. And if only corporate borrowers are taxed, pooling of capital will be inefficiently discouraged. Finally, if borowing is taxed but section 351 continues to favor corporate borrowing at the time of formation, firms may inefficiently dissolve or sell their assets to firms that are first forming. More pressure would also be put just where the corporate tax system has the most difficulty, on the treatment of liquidation-reincorporations.

It is even more difficult to imagine tax law's discouraging fiddling with the denominator of the debt-equity calculus, the issue and distribution of equity shares. The inefficiencies of various alternatives are obvious enough and, as a legal matter, it should suffice to note that even the non-taxation of pure stock dividends has a history that borders on constitutional invincibility.[36] In sum, while only radical changes in tax law would leave firms and investors entirely free to arrange capital stuctures in ways that minimized agency costs, my point is that within its own historically and economically determined confines tax law supports rather than intrudes upon the practical lessons of modern financial theory with regard to capital structure.

III. The Positive Role of Tax Law in Stock and Asset Acquisitions.

Consider also the tax treatment, as of 1983 and in force with somewhat different import after 1986, of an acquisition of a target, T's, stock by an acquiring corporation A. Assuming that A pays cash (or that it uses its own stock to effect this acquisition but that it intentionally fails the requirements for a tax-free reorganization[37]) there are means by which A can get credit for its purchase price toward the tax cost of "stepping up" the basis of T's assets for depreciation purposes. Had A purchased T's assets rather than stocks, this step-up would have been automatic, so that any means provided by tax law for asset step-ups in a stock acquisition ought to be viewed as an attempt to be neutral, or non-intrusive; if A can only step-up asset bases through one method of acquisition, then tax law will have intruded on this important business decision.[38] When A purchases less than 80% of T's stock, it is easy to step up T's assets -- although under the Tax Reform Act of 1986 it may be unattractively costly to do so. A simply liquidates T. This liquidation is an occasion for recognition and normally generates a tax at the shareholder level, under section 331, and a step-up (in the assets' bases), under section 334, but here the former is painless because A, having just purchased T's stock from shareholders of T (who will themselves have paid tax on any previously unrecognized appreciation when selling these shares), will have no gain to report on the shares of T that are exchanged in liquidation. When the Tax Reform Act of 1986 applies, the liquidation will also trigger a corporate level tax, under new section 336, so that the step up may come only at the price of two taxes. In the absence of a preference for capital gains (that is, under the initial rule of the 1986 Act), an acquisition and liquidation of the sort just sketched would require a strong non-tax motivation.

As every student of corporate tax knows, special Code provisions are needed only when A owns more than 80% of T's stock. The liquidation of T is then a tax-free reorganization, with no step-up in asset basis.[39] Section 338 works in this setting to preserve neutrality (more or less) between stock and asset acquisitions. One could stop here, sketch section 338, and repeat the main point about the positive role of tax law; the very idea that 338 and its predecessors have been meant to ensure that acquirers (and sellers) not be limited to just one form of transaction strongly supports the point that tax works hard to avoid intrusions. Indeed, this tiny corner of tax law, in which stock acquisitions entitle taxpayers to step up the bases of assets, is an excellent example of the positive role stressed in this paper.

But the role played by section 338 is deeper, richer, and more striking that what first meets the eye. The rather intricate mechanics of that section contain less obvious evidence about the positive interaction between tax and corporate law. These mechanics, summarized presently, are most easily understood if one bears in mind that the Code's treatment of business sales is generally, at least through 1986, to collect one full tax (on all as of yet unrecognized appreciation, or gain) and to give, in return, a full step-up in basis to the level of present fair market value. In the case of these stock acquisitions it is useful, therefore, to be mindful of the taxes collected from the past and present shareholders of T, other than A. Although the Tax Reform Act of 1986 collects <u>two</u> taxes in some acquisitions rather than one, section 338 continues to play a good part of the role it played in the one-tax scheme.

In the pages that follow, I present an argument about the positive role of tax law in terms of the rules in place <u>before</u> the Tax Reform Act of 1986. The reasons for using these rules as opposed to the "new" rules are several. First, the argument is more elegant under the older rules, and my purpose in this essay is to explore the nature of the interaction between tax law and corporate law rather than to sketch the latest rules on corporate acquisitions. Occasional notes should assist the purist who wishes to reformulate the argument in terms of the 1986 Act. Second, since the Tax Reform Act of 1986 imposes, essentially, two taxes rather than one on complete corporate acquisitions, the details of the argument are made more complex because there are two taxes rather then one to keep in mind. As we will see shortly, the matter is sufficiently complicated with one tax in tow. Finally, and not unimportantly, the old rules are by no means obsolete. A fair number of transactions initiated before August, 1986 are grandfathered and are to be treated under the old rules.[40] Moreover, the old rules apply up to 1989 for target corporations whose stock is held by ten or fewer individuals (including trusts and estates) and whose value is less than five million dollars. Corporations worth more than five but less than ten million dollars are entitled to some of the old (one-tax rather than two-tax) treatment on their liquidation.[41] In short, not only will the argument be easier and more fun to follow in one-tax terms but also the one-tax ("General Utilities") world is still with us for some time, even if no future legislative changes return us to its rules more completely.

Section 338 works[42] as follows:

(1) If A buys 100% of T's stock, then it can elect to step up the basis of T's assets (as if they were sold) without paying any tax.[43] Note that all those who sold stock to A will pay taxes.

(2) If A buys between 80% and 100% of T's stock, then there is a full 100% step-up as if all the assets were sold to A in a taxable transaction, but T (now controlled by A) must pay tax on the hypothetical sale of these assets according to how many old T shareholders have not sold--and therefore not paid tax on appreciation in--stock to A. Thus, if A buys 85% of T's stock and elects under section 338, then there is a complete step-up of T's assets but T must pay 15% of the tax that would be due if all T's assets were sold in taxable transactions. If A buys 95% of T's stock, then it pays tax on 5% of the asset appreciation, and so forth.

(3) Finally, for those who do not follow corporate tax law but would like to know that the system is comprehensive, if A buys more than 80% of T's stock, and long ago purchased some T stock, then it can still choose a complete step-up in T's assets but must pay tax on its own old holdings of T stock (which are then stepped up as well).[44]

I will argue that these rules are remarkably sensitive to the decision-making processes which surround tender offers, but first it is useful to sketch alternative means by which section 338 could have allowed a step-up in basis (to maintain neutrality between asset and stock acquisitions) and collected one tax. It is the alternatives to rule (2), when A buys between 80% and 100% of T's stock, that are most relevant. When A has just purchased 85% of T's stock, for example, it will be recalled that a 100% step-up follows an election of section 338, and a 15% "asset tax" is collected from T--inasmuch as 15% of the T shareholders have not sold their stock and recognized gain.

(2A) The Code could have chosen instead to give a step-up only to the extent that a tax has been collected from the shareholders who sell to A. When A purchases 85% of T stock, an 85% step-up would follow. A might be able to freeze out the remaining shareholders and, in return for the taxes they pay, get a full step-up.

Approaches (2) and (2A) suffer from what can be called a "correspondence fallacy" that lurks throughout much of corporate tax. Unrecognized gain is unlikely to be distributed evenly across the outstanding stock of a firm. As such, the unrealized (or unrecognized) gain represented, for example, in ten percent of the outstanding stock of a company is unlikely to equal exactly the unrealized gain in ten percent of that firm's assets. When <u>all</u> the stock appreciation is taxed, the government can be sure that it has received the equivalent of a tax on all asset appreciation, because the market value of the stock presumably represents (at least) the gains in the real assets held by the corporation, but when less than all the stock has been traded and taxed, there is no way of knowing in the abstract what part of the overall unrecognized gain (contained in all the stock or all the assets) is in this subset of the stock. Indeed, to the extent that old shares with much untaxed appreciation are the least likely to be traded on a given day, a scheme that steps up assets according to the percentage of stock that is recently traded will give step-ups too cheaply (at least when compared to the treatment of a 100% stock sale and step-up). Moreover, taxpayers will surely take advantage of the correspondence fallacy and adversely select against the fisc by readily electing 338, under version (2) or (2A), whenever the unsold stock contained a disproportionately high share of unrecognized gain. Inefficient acqusitions might also be generated by such rules because tax advantages, in the form of depreciation deductions from higher bases, would be available from otherwise inefficient, unprofitable transfers of control when unrecognized gain was disproportionately contained in relatively few unsold shares.

To see this correspondence fallacy, imagine that a firm begins with 10 shares, owned by A and B, and $10 invested in a machine, but that over time both come to be worth $1,000 because of inventions or marketing by employees of the firm. The firm now sells 90 shares to new investors, who contribute $100 in assets for each share, which will now have a 1/100 claim on an enterprise worth $1000 + (90)($100) = $10,000. If, after a year or so and no further appreciation, the 90 new shareholders all sell their stock to A, they will have no gain to report, but a section 338 election can be made by A. T will need to pay, on behalf of the nonselling shareholders, 10% of the tax that it would have paid in a complete and taxable asset sale, or the tax on 10% of $990. The machine's basis is completely stepped up to $1000 even though only 10% of its appreciation has been taxed. This is the correspondence problem inherent in section 338, rule (2).

Under alternative (2A) the correspondence problem is at least as great as it is under (2). Continuing with the above example, under (2A) the machine would be stepped up 90% of the full differential between adjusted basis ($10) and fair market value ($1000), or from $10 to $901 with no tax cost at all. Superficially, the correspondence fallacy is the same under (2) and (2A). Both rules might be said to give the first $891 of step-up at no tax cost, but under (2) the corporation must continue on and take another $99 step-up at the cost of a corporate level tax on $99 of gain. Sometimes this extra step-up under (2) will be welcomed by the taxpayer, perhaps because some depreciation schedules are friendly to investment; sometimes it will be unwanted, because it involves an immediate tax liability with consequent depreciation deductions coming mostly in later years; and sometimes the extra step-up will be a matter of indifference because the advantages of increased deductions and the disadvantages of a present tax liability will be offsetting. My own sense is that (2) and (2A) will often be roughly equal from the perspectives of the taxpayer and the government, but that in a significant subset of acquisitions the loss to the government arising out of the correspondence fallacy is likely to be greater in (2A) than in (2). Put differently, taxpayers would in the aggregate have preferred (2A). Approach (2) essentially forces additional gain recognition, and there is reason to think that taxpayers generally prefer to have maximum control over the timing of recognition. Approach (2A) would allow a large step-up at no tax cost; this is obviously quite attractive (and if assets have depreciated, section 338 need not be elected). In contrast, (2) gives this large step-up at the cost of recognizing gain and getting an additional step-up. It thus removes from the taxpayer some control over the timing of recognition. In short, (2) and (2A) may suffer from equal correspondence fallacies, in which case the rejection of (2A) in section 338 can simply be regarded as a matter of indifference, but it is more likely that the correspondence fallacy in (2A) is a bit more serious; the rejection of (2A) in section 338 can thus be understood as a decision to minimize the correspondence problem.

The correspondence problem might have been avoided altogether, while collecting one full tax and giving a complete step-up, in the following manner, alluded to in the 1982 changes to the Code and suggested by a case that was widely regarded as too harsh to nonselling minority shareholders:[45]

(2B) Permit a full step-up of T's assets, even when A has bought, say, only 85% of T's stock, but collect a tax from the non-selling shareholders of T. By imagining and forcing these non-selling shareholders to sell their T stock to themselves and to recognize gain, the correspondence fallacy is avoided for there is 100% recognition.

With alternatives (2A) and (2B) and the notion of the correspondence fallacy set out, we are now positioned to consider the interaction between the mechanics of section 338 and the dynamics of the market for corporate control. The nonselling shareholders--as opposed to offerees in general-- will surely be pleased to learn that (2) rather than (2B) is the treatment afforded by section 338. Alternative (2B) would often be unattractive to them because, in contrast to the normal tax law rules which allow the individual to decide on the timing of such recognition, it would force gain recognition. In some settings, these nonselling shareholders may have dissented from, or turned down, A's offer for their stock precisely because the tax consequences of a sale made the offer less attractive than it was to most other shareholders. Here, the ability to control the timing of recognition is relatively clear.

It is a difficult question whether economic efficiency would be promoted by (2B)'s insensitivity to the nonselling shareholders' personal tax consequences. It is arguable that the market for corporate control works best by owners' deciding whether to accept an offer, await other offers, or hope that current management will over time cause shares to be worth even more than what a bidder offers. Inasmuch as tax law, by collecting revenue when there are recognition events, already intrudes on this decision, it is possible that this distorting, inefficient intrusion could be neutralized by a rule that withdraws from a shareholder the ability to trigger or prevent such a recognition event. Put differently, nonselling shareholders may have good (tax) reasons to turn down offers for their shares, but it may be in society's interest to encourage a decision on each offer that is unaffected by tax considerations; (2B) may thus be good for the market although costly to some individuals.

A problem with this argument is that it tries to stop short of repeating the familiar notion that the tax system would be less intrusive if changes in wealth or consumption were assessed daily or yearly rather than calculated only when certain recognition events took place. It is true that shareholders may reject offers from acquirers who signal that they could put the firm's assets to more productive use simply to postpone their personal tax liability; less money taxed later is, unfortunately, more attractive than more taxed now. But what are the alternatives to the present regime? Alternative (2B) may itself generate perverse behavior for targets as a whole, acting through their managers, may resist acquisition more strongly in order to avoid tax liabilities. Same shareholders may be able to pay or influence the firm to behave in this way, whereas without (2B) they have less reason to care about the responses of their fellow shareholders. More generally, (2B) does not cause offerees to ignore taxes and focus on "real" things, because if enough shareholders decline the offer, then no qualifying 80% acquisition will take place and section 338 (along with its hypothetical component (2B)) can not be triggered. And it obviously will not do to suggest that this distortion in the responses of offerees be avoided by decreeing that all offers of acquisition trigger a tax, so that target shareholders do not include tax considerations in the calculus of their responses, because it will be difficult to distinguish true offers from strategic offers. Any further step in this direction is nothing more than a call for daily recognition of gain and is far enough outside the norms of the present tax system that it is best set aside.

We have, then, two alternatives to part (2) of section 338; (2A), which would allow a step-up only to the extent that taxes have been collected from selling shareholders, and (2B), which would give a full step-up but force taxes out of all nonselling shareholders along with those collected from sellers. Each is unattractive; (2A) because the correspondence problem is probably greater under its terms than under those of (2) and (2B) both because as a matter of legal tradition it suggests the unthinkable[46] and because it forces shareholders in a way that seems unfair in the context of a system that normally allows taxpayers to control the timing of recognition events.

With all this in mind, the design of part (2) of section 338 can itself be reexamined. It compromises on the correspondence fallacy, as we have seen, but how does it affect offerees' inclinations to accept or reject offers for their shares? At first glance, the design seems badly flawed because when the corporate-level tax on appreciated assets is paid "on behalf of" the (less than 20%) nonselling shareholders, no step-up or other credit is given to these shareholders, so that there is potential for overtaxation in comparison to the complete stock or asset sale norm. Imagine, for example, that T's assets have risen in value from 100 to 200, that T has 100 shares outstanding with basis of 1 and value of 2 each, and that 80 of the 100 shares were sold to A which elects under 338 and, therefore, pays tax on 20% of the $100 asset appreciation. If the nonselling shareholders soon sell their stock (to A or some other purchaser) then they will pay tax on their gain. Thus, the government could collect tax on $80 from the first group of selling shareholders, $20 from T after the 338 election, and $20 from the second group of (originally nonselling) shareholders, or tax on a total of $120 when only $100 would have been taxed in a normal stock or asset sale. Put differently, section 338, contrary to its obvious purpose, intrudes upon the choice between an asset and stock acquisition, for the tax bill associated with the latter can be more expensive.[47]

Having examined the alternatives to part (2) of section 338, however, we can quickly see that the failure of 338 as just described may simply be the least of all evils. It would hardly do to forgive the last tax that is paid by minority shareholders who eventually sell, or, equivalently, to give the nonselling shareholders a step-up in the basis of their stock in T when a partial asset-based tax is paid "on their behalf" by T. After all, this will strongly encourage offerees to reject an offer -- even when it is one they think beneficial -- hoping that it succeeds at the 80% level and is followed by a section 338 election. This set of events would not only allow those who turn down the offer to benefit by paying less than their proportional share of the tax cost of a full step-up in the corporation's assets but also will give them a tax-free sale of their stock. Any hope of neutral, efficiency-enhancing responses (to offers), or responses not mostly influenced by tax considerations, depends therefore on not treating nonsellers much better than sellers. And since we have seen that the alternatives to part (2) of section 338 are also flawed, it is arguable that the imperfection in (2), including the potential for overtaxation, is, in fact, the least of all evils. Even this imperfection, it should be noted, will sometimes be avoidable; after an 80% acquisition, the acquirer and the nonselling shareholders may be able to strike a deal to liquidate within a year, in which case the nonsellers will finally pay a tax and, appropriately, section 338(c)(1) will forgive the asset-based tax that would otherwise be collected from the target in return for the full step-up.

I suppose that it might have been slightly more elegant to try one last alternative:

(2C) Give a 100% step-up, collect a tax from the target "on behalf of" the nonsellers, and give the nonsellers a "corresponding" rather than a full step-up in their stock basis. This partial step-up could even be linked to the asset-based tax paid by the target. Some overtaxation will be prevented this way and yet no incentive to dissent would be created.

Imagine, for example, that every one of 10 shares of the target has basis of 10 and value of 100, that its assets have appreciated from 100 to 1000, and that only one share is not sold to the acquirer who elects under 338. Approach (2C) gives a full asset step-up, extracts a tax on 100 minus 10 from the nine shareholders (9 x 90 = 810), collects a corporate-level tax on 10% of the 900 (or 90% of the) asset appreciation, and -- unlike (2) -- gives the nonselling shareholder a basis in his stock of 19.

This step-up of 9 is equal to the proportion, 10%, of the asset appreciation (90) taxed to the corporation because of this nonseller. This corresponding, or partial, stock basis step-up is probably insufficient to encourage dissent, or nonselling, for in dissent one might indirectly pay a greater part of taxes paid on behalf of nonsellers.

Had (2C) been the alternative chosen in tax law, one would be unable to overstate the positive interaction of corporate and tax law in the context of acquisitions; inasmuch as (2) comes very close to (2C)--and is administratively much simpler[48]--I feel comfortable arguing that we have found an impressive example of the positive role of tax law. Not only does 338 aim in a rather obvious way to give acquirers the flexibility of both asset and stock acquisitions but also the mechanics of stepping up asset bases in stock acquisitions reflect remarkable sensitivity to the dynamics of stock sales. The Code appears elegant and efficient rather than intrusive.

Conclusion

One could not possibly claim that taxes do not intrude upon or distort decisions that take place in corporate and capital markets.[49] It is easy to wish that tax reform would focus on those intrusions that are neither trivial nor inevitable. On the other hand, I have suggested in this paper that the interaction between taxes and corporate and capital markets is not always negative.

There is some reason to think that the positive interactions described in this paper are not accidental in the evolutionary sense, either because the drafters of the relevant Code sections knew just what they were doing or, more likely, because they could glimpse some weaknesses in the alternatives that they might have chosen. On the other hand, the more one can explain those areas of tax law that interact positively with various policy goals, the more mysterious or troubling are those areas in which taxes appear to be violent intruders. But whatever the explanation of the positive role of tax law, it is not unlikely that the study of positive interactions between tax and other law would help reformers who choose to tackle the negative ones.

THE POSITIVE ROLE OF TAX LAW IN CORPORATE AND CAPITAL MARKETS

Footnotes

*Professor of Law, University of Virginia; Visiting Professor, Yale Law School 1986-87. Alan Averbach, Henry Hansmann, Roberta Romano, Paul Stephan, and participants at a Harvard Law School Conference on The Economics of Corporate and Capital Markets provided helpful suggestions.

1. The intrusion is not, of course, limited to capital assets; inventories, for example, might be accumulated and disposed of differently in the face of taxes triggered by transactions. I have, however, slanted the generalizations in the text toward matters most relevant to competitions for corporate control and other topics of current interest.

2. To the extent that transactions are voluntarily entered into and are the means by which assets move to their highest value uses, taxes can be said to cause a reduction in welfare. The question is often, of course, how to raise revenue (for projects that may improve welfare) in a way that is least harmful. See generally Feldstein, Slemrod, & Yitzhaki, The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains, 94 Q.J. Econ. 777 (1980); Feldstein, Personal Taxation and portfolio Composition: An Economic Analysis, 44 Econometrica 631 (1976); Sprinkel & West, Effects of Capital Gains Taxes on Investment Decisions, 35 J. Bus. 122 (1962).

3. Tax law thus causes corporate and individual

shareholders to have very different attitudes toward the distribution of dividends. Note that the elimination of the preference for capital gains when the Tax Reform Act of 1986 does not make shareholders indifferent between dividends and stock sales; when selling stock, shareholders are given immediate credit for the cost, or basis, of their stock.

4. If, for example, the firm can earn 10% on its next available project and shareholders can earn 11% on their own, reinvestment rather than distribution may nevertheless occur because of the tax cost of the distribution. Shareholders may also prefer to invest at 11% with funds they will borrow on the strength of their shareholdings which, in turn, are positively affected by the firm's retention of earnings. In general, tax laws probably encourage larger businesses. See A. Feld, Tax Policy and Corporate Concentration 55-99 (1982) (treatment of retained earnings and reorganizations encourages big businesses).

5. For the seminal presentation of the agency cost insight <u>without</u> taxes, see Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

6. The question is much-debated. Compare Modigliani & Miller, The Cost of Capital, Corporation Finance and the Theory of Investment 53 Amer. Econ. Rev. 261 (1958) and Miller, Debt and Taxes, 32 J. Fin. 261 (1977) with, especially, Myers, The Capital Structure Puzzle, 39 J. Fin. 575 (1984). See also Ross, Debt and Taxes and Uncertainty, 40 J. Fin. 637 (1985). On the possibility that reactions are bifurcated, see Auerbach & King, Taxation,

Portfolio Choice, and Debt-Equity Ratios: A General Equilibrium Model, 98 Q.J. Econ. 587 (1983).

Note also that while losses suffered by one enterprise can only sometimes be applied against gains of another or gains at a different time, a large enterprise can normally offset gains against losses as a matter of course. The treatment of losses is thus "intrusive" and encourages large firms even though such enterprises <u>may</u> be suboptimal as a matter of agency costs or other "real" concerns.

7. The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603 (1975); Life Insurance Company Taxation: The Mutual vs. Stock Differential (M. Graetz ed. 1986).

8. There is, of course, an enormous literature on the assessment and collection of property taxes. Unfortunately, less work is done on employment related taxes. See also Kelly, Taxes, Depreciation, and Capital Waste, 24 Natl. Tx. J. 31 (1971).

9. See Campisano & Romano, Recouping Losses: The Case for Full Loss Offsets, 76 Northwestern L. Rev. 709 (1981).

10. See Lintner, Distribution of Incomes of Corporations among Dividends, Retained Earnings, and Taxes, 46 Amer. Econ. Rev. 97 (1956). See also Brennan, Taxes, Market Valuation and Corporate Financial Policy, 25 National Tax. J. 417 (1970).

11. Campisano & Romano, supra note 9; Fellingham & Wolfson, Taxes and Risk Sharing, 60 Acctg. Rev. 10 (1985).

12. On leasing, see R. Brealey & S. Myers, Principles of Corporate Finance 547-61 (2d ed. 1984). For a discussion of the choice among the partnership, corporate, and "S" Corporation

forms, see Thompson, The Federal Income Tax Impact of the Operating Function on the Choice of Business Form: Partnership, Subchapter C Corporation, or Subchapter S Corporation, 4 Black L.J. 11 (1974); The S Corporation as an Alternative Form of Business Organization After ERTA, TEFRA and the Subchapter S Revision Act of 1982, Wolfe & DeJong, 32 DePaul L. Rev. 811 (1983).

13. Prior to the Tax Reform Act of 1986, the basis of a firm's assets could be "stepped-up" (advantageous for depreciation purposes) at the cost of one capital gains tax. The general point was not lost on legislators. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 281-282 (tax benefits induce liquidations and asset transfers).

14. See, e.g., Hulten & Robertson, The Taxation of High Technology Industries, 37 Natl. Tx. J. 327 (1984).

15. See Canellos, The Over-Leveraged Acquisition, 39 Tax Lawyer 91 (1986).

16. Issuers could be required to withhold taxes unless payees demonstrated or affirmed that they pay tax.

17. Of course, not everyone agrees that the expected value of bankruptcy is low. Compare Gordon and Malkiel, Corporation Finance, in How Taxes Affect Economic Behavior (1981) and R. Brealey & S. Meyers, supra note 12, at 390-401 (bankruptcy costs have great effect on the debt-equity balance) with Maugen & Simbet, The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure, 33 J. Fin. 383 (1978).

18. See Jensen & Meckling, supra note 5; Levmore, Monitors

and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49 (1982).

19. See I.R.C. §§301, 351. The uninitiated reader might consult B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (1979).

20. Shareholders who contribute property in midstream to an ongoing corporation may also be able to receive nonrecognition treatment under section 351, although it may be more difficult to satisfy the control requirement of section 351. Inasmuch as this possibility may at first seem to contradict the argument developed in the next few pages, it is important to note here that any ability to alter (cheaply) the capital structure, or debt-equity balance, of the firm is in this way constrained by the value of the property transferred.

21. Note that if recognition is desired by the taxpayer in order to earn a stepped-up basis for the property transferred, for example, then the corporation can be started without bonds and it can borrow (against the new collateral) after incorporation. Section 351 is thus quite friendly because it is mostly elective.

22. A reader unfamiliar with the elegance and reach of the invariance notion might review W. Klein & J. Coffee, Business Organization and Finance 272-95 (2d ed. ed. 1986) or R. Brealey, S. Myers, supra note 12, at 377-83.

23. See M. Chirelstein, Federal Income Taxation 234-45 (4th ed. 1985) (showing how rules seem to include initial borrowing in and exclude subsequent borrowing from basis but how a taxpayer can include both if he so desires). I should point out that if

one views all this as a problem, because taxpayers can use appreciated assets as a means of borrowing for immediate consumption purposes and yet defer recognition, it will not do to tax borrowing in specific assets only. Such a rule would discourage secured transactions which may have an important economic purpose (in the form of reducing agency costs). The solution then would require that all borrowing be taxed, and this creates a different set of problems.

24. That is, that all the parties have sufficient other incometo make interest deductions useful. I might add an assumption that any rules discounting "passive income" be unconstraining, although such rules might strengthen the argument that follows. It might also be helpful to assume away any problems arising from the Internal Revenue Service's recharacterizing debt as equity.

25. See Miller, supra note 6.

26. The debt-equity ratio <u>can</u> be altered at no tax cost by contribution of unappreciated property in return for bonds or by corporate-level borrowing from banks, for example. The argument in the text goes on to point out that <u>these</u> devices are difficult to block without other intrusions. The point is not that all debt-equity manipulations are discouraged but rather that tax law strikes at those that can be easily discouraged.

27. The financier will not want his coventurers to be prepaid for their services in any way that allows them to walk off with this compensation before contributing all effort expected of them. The point is illustrated and developed in

Herwitz, Alocation of Stock Between Services and Capital in the Organization of a Close Corporation, 75 Harv. L. Rev. 1098 (1962).

28. See R. Brealey & S. Myers, supra note 12, at 385; A. Auerbach, The Taxation of Corporate Income 87-90 (1983) (in the context of an argument that wealth maximization is not accomplished by maximizing the firm's market value); King, Taxation and the Cost of Capital, 41 Rev. Econ. Stud. 21, 25-29 (1974).

29. If one believes in signalling explanations of the mystery of dividend distribution, then I suppose it is tempting to go on and argue that midstream debt distributions come at a high tax cost but may also be worthwhile as signals of the successful firm. These signals seem awfully expensive. Moreover, we do not observe as many successful firms' distributing debt to its shareholders as we do firms' distributing cash dividends. The market thus appears to have developed one signal and not the other (perhaps because debt also throws shareholders' homemade portfolios off balance).

30. I.R.C. §306; B. Bittker & J. Eustice, supra note 19, at ¶10.04. The centerpiece of the system provides that if the shareholder sells the stock, and thus reveals that this stock is not to be held as part of some long-range scheme to promote intergenerational succession, then an ordinary income tax is collected to the extent that earnings and profits were sufficient for such a tax at the time the preferred stock dividend was first distributed.

31. Tax is collected only if the preferred stock is sold or

redeemed whereas bonds are taxed right away. It would be possible to "wait and see" what will happen with the bonds, as is done with preferred stock, but the Code does not. See Levmore, Identifying Section 306 Stock: The Sleeping Beauty of Revenue Ruling 66-332, 2 Va. Tax Rev. 59 (1982).

32. Id. at 61 n. 15.

33. Its role may be explicable in the terms of portfolio theory itself or, perhaps, through agency cost theory. See Levmore, supra note 18, at 74-75. There may, of course, be a simple tax explanation for preferred stock in the hands of corporate investors, R. Brealey & S. Myers, supra note 12 at 288-89, but reliance on this explanation makes the argument in the text circular.

34. The investor would need to contract for a nonrecourse loan bearing "interest" that depended somewhat on the performance of a particular firm. We need not go on and imagine the homemade counterpart to a provision giving preferred shareholders the right to elect directors in the event that dividend payments are missed, because it should be clear that it would be difficult and expensive (in transaction cost terms) to find someone to extend such a loan.

35. It would be terribly odd and inefficient to tax someone who invests 300 and comes out with 600 much differently from one who began with 100 and emerged with 400. Of course, the best method of giving credit for investment is slightly less obvious. See M. Chirelstein, supra note 23, at 25-28.

36. See B. Bittker & J. Eustice, supra note 19, at ¶7.60.

37. Some acquirers will, in effect, be able to choose whether to "reorganize" with the target and inherit most of the target's tax attributes, including asset bases on which depreciation deductions are figured, or to purchase the target's assets or stock and allow the target to step-up (or force it to step down) its asset bases for depreciation purposes. Other advantages and disadvantages, such as the recapture of earlier deductions may also be at stake in this choice. Roughly speaking, the latter (step-up through purchase) route requires a tax on previous appreciation while the reorganization route can allow unrecognized gain to continue unrecognized.

38. If asset acquisitions are more attractive than stock acquisitions, then incumbent managers will have greater power to prevent takeovers or demand side-payments for their role in enabling such takeovers.

39. I.R.C. §§332, 334(b). See new §337.

40. Tax Reform Act of 1986 §633(c).

41. Tax Reform Act of 1986 §633(d).

42. The Tax Reform Act of 1986 §631(b)(2) repealed §338(c) and, therefore, the mechanism described in the text presently as step (2). The use of the present tense in the text's description of §338 must therefore be understood as applying to small or grandfathered corporations.

43. Under the Tax Reform Act of 1986 §631 (repealing the General Utilities rule which had forgiven corporate level recognition of gain upon liquidation) there will be a single tax.

44. I.R.C. §338(b). This feature of §338 survives the 1986 Act.

45. May B. Kass, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d. Cir. 1974).

46. See supra note 35 and accompanying text.

47. The tax bill could also be lower because of a combination of the correspondence problem and deferral.

48. It is not unusual for the code to choose what is conceptually a second-best solution, when the first-best comes at higher administrative or articulation costs.

49. Even if present stock prices take all things into account, it is still the case, for example, that at the margin the tax system's taste for recognition rather than periodic appraisals affects the decision to hold or sell an asset.