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AN ANALYSIS OF ACCOUNTING AND TAX CONSIDERATIONS WHICH AFFECT CONGLOMERATE GROWTH

When one thinks of private enterprise, the concept of maximum profits arises automatically. Originally this concept was practiced in an internal sense only, that is, by widening the gap between total costs and total revenues. Economies of size, volume purchases, and new technology were all considered beneficial to the healthy growth of any business. In the 1800's, with the increase of publicly held corporations, a new way to expand earnings arose. This new pattern of growth exhibited the external generation of profits via the acquisition of profitable going concerns.

Many, if not all, of these early acquisitions were motivated by reasons not directly connected with the acquisition of profits because the acquirers' primary concern was with the accumulation of assets. Vertical and horizontal mergers were, for the most part, based upon the philosophy of ensuring sources of supply and "capturing" outlets of the acquired firm's products. Thus a situation began to emerge wherein businesses, with large amounts of capital, were able to increase their profits substantially: 1) by limiting their costs, 2) by limiting the ability of their competition to acquire raw materials, or 3) by acquiring their competitors. These practices, unfortunately for the capitalist purist, have been severely restricted by the Federal Government and its antitrust legislation.¹

A new breed of businessman has arisen over the last two decades, with whole new approaches aimed at achieving the same results in terms of profits that their predecessors so successfully originated. These twentieth century frontiersmen of business consolidations no longer look to related businesses for their acquisitions. They will actively seek out and acquire businesses with proven records of good earnings or strong asset positions. Even though the acquisitions may not enhance the original line of business practiced by the acquiring company, the combination of the profits and assets of the various enterprises combined usually reflects a highly successful concern. The owners of these multifaceted enterprises, the stockholders, are very pleased when their return on investment continues to increase over the years. There is absolutely no reason, economically speaking, why the diverse owners of today's large businesses should be limited to singularity of operation.²

¹ For an analysis of the development of American economics and the merger movement see R. GILL, *EVOLUTION OF MODERN ECONOMICS* (1957) and S. REID, *MERGERS, MANAGERS, AND THE ECONOMY* (1968).

² Donald Turner has defined these "new" types of business mergers as all acquisitions

When one considers the evolution of business growth in combination with the highly popular modes of acquisition, the stock-for-stock or stock-for-asset transfer, one begins to understand how the growing concern enlarges itself by combinations. As each acquisition is made, earnings rise, thereby increasing the market value of the acquiring firm's stock. This phenomenon occurs because investors value their stocks at a multiple of earnings. A share of stock, like any investment, should return a fair yield. As the earnings of any given company rise, the yield on that stock rises, thereby increasing the demand for that company's stock. Increased demand, coupled with speculations of even greater acquisitions in the days to come, operates to drive the market value of the acquirer's stock higher and higher. This elevation in market value allows a firm to engage in further acquisitions due to the greater purchasing power of the elevated stock interests. For example, when one company acquires another with its own stock, rather than with cash or other assets, it is giving the owners of the acquired firm a valued investment, partial ownership of the acquirer, in exchange for ownership of the acquired firm. This assumes that the acquired firm is not in a position to initiate acquisitions of its own.

There are many other factors which influence corporate merger other than the mere acquisition of external earnings. The acquiring firm may desire to enter a field of product supply without going through the agonizing process of start-up costs and market segmentation. But no matter what the reason, the result will usually mean increased earnings for the combined enterprise. Another effect acquisitions have, which serve to greatly increase the value of the acquirer's stock, is to influence the price the investing public will pay for different stocks.

Assume X company was able to command a price earnings ratio on its outstanding common stock of 5 to 1. This would mean that the stock would be valued at five times the earnings per share. These ratios are caused by the prevailing demands for investment yields plus speculation as to the profit growth of the company. If X acquires Y which has only a 4 to 1 price earnings ratio, the effect will be to escalate the retained earnings

other than:

(1) acquisition by a producer of the stock or assets of a firm producing an identical product or close substitute and selling it in the same geographical market—the simple horizontal merger; and (2) acquisition of the stock or assets of a firm that buys the product sold by the acquirer or sells a product bought by the acquirer—the simple vertical merger. The area ranges from the pure conglomerate, in which there are no discernible economic relationships between the businesses of the acquiring and the acquired firm, through a variety of what may be called mixed conglomerates, involving horizontal or vertical economic relationships other than those characteristic of the simple mergers just described. Mixed conglomerates include acquisition of a firm producing the same product as the acquirer but selling it in a different geographic market, and acquisition of a company manufacturing a different product which is nevertheless related to a product or products of the acquiring firm because it can be produced with much the same facilities, sold through the same distribution channels, or made a part of the same research and development efforts. Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1315 (1965).

of the acquired company to the higher level of the acquirer. This financial miracle occurs because the investing public has been satisfied. Its company, X, having increased its earnings, thereby meets their demand for satisfactory yields on investments and fulfills their growth expectations. So long as the X shares given up do not dilute the earnings of the X shareholders below the pre-acquisition level, the miracle works. Of course this will not be true if X company makes a bad merger, but careful analysis of the probable effects of each and every merger is undertaken before the actual acquisition offer is made to prevent such a result.

In addition to the enhanced earning position gained through acquisition, the acquiring company has the ability to make use of varied accounting techniques to make the acquisition appear in its best light. We shall now examine the accounting options available for conglomerate mergers to see just what a company can achieve by selecting alternative accounting methods for recording the acquisition. But before we can understand the benefits of choice, we must understand the choices themselves and their reasons for existing.

I. ACCOUNTING CONSIDERATIONS SPECIFICALLY RELATED TO CONGLOMERATES

A. *Methods of accounting for the conglomerate merger*

1. *Purchase method.* The theory behind accounting for a merger as a purchase is analogous to accounting for any other asset which a corporation purchases. The acquired firm is recorded at its fair market value as an asset of the conglomerate. This increases the asset base upon which the conglomerate is to produce its rate of return.

A purchase of the assets or stock of one or more corporations by another corporation is recorded at the cost value³ of the net assets or stock of the acquired company without carrying forward the retained earnings.⁴ The Appendix illustrates the recording of an acquisition by the purchase method. If the following factors are present, they operate to indicate a corporate acquisition should be accounted for as a purchase:

- (a) the elimination of an important part of the ownership interests in the acquired firm;

³ APB ACCOUNTING PRINCIPLES § 1091.09 provides:

When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

⁴ APB ACCOUNTING PRINCIPLES § 1091.03 provides:

For accounting purposes, a *purchase* may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.

- (b) a material alteration of the voting rights of the constituent corporations;
- (c) the elimination or reduction of the influence of the management of the acquired corporation (A frequent merger objective is to utilize the experienced management of the acquired corporation.); and
- (d) where one of the constituent corporations is clearly dominant—obtaining 90 to 95 per cent of the voting interest of the combined enterprise. (This appears to be an arbitrary presumption because choice of an appropriate accounting method should not be governed by the relative size of the corporations. Relative size does not determine the nature of the economic relationship of the combining firms which is to be reflected by the appropriate accounting method.)⁵

The purchase method does not permit the conglomerate to increase its earnings by adding the earnings of the acquired firm to those of the acquiring firm. Rather, it embodies the theory that an asset has been acquired, be it the assets or stock of the acquired corporation. There is no joining of ownership interests into a common enterprise, as the pooling of interests method is meant to reflect. The acquiring corporation has added a new asset to its books, and in exchange for this asset it has given up either a previously owned asset or an equity interest in itself. It would be illogical and in violation of sound accounting theory to treat both the acquisition of assets and the equity interest of the acquired company as continuing into the acquiring company. The equity interest now owns new assets, the assets, debt or stock given up by the acquiring corporation for the assets of that which was acquired.

2. *Pooling of interests method.* The theory behind accounting for a merger as a pooling of interests is that the financial and management resources of the combining firms are pooled for more efficient and effective administration. The Appendix illustrates the recording of an acquisition by the pooling of interests method.

Pooling occurs when two or more corporations combine for reasonable business and economic reasons and the holders of a substantial portion of the ownership in the constituent corporations become owners of a single entity which owns the assets and businesses of its constituents.⁶ Common

⁵APB ACCOUNTING PRINCIPLES §§ 1091.05-.06. The method of evaluating these factors is suggested in § 1091.07:

No one of the factors discussed in paragraphs .05 and .06 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances.

⁶ APB ACCOUNTING PRINCIPLES § 1091.04 describes pooling of interests for accounting purposes to be:

[A] business combination of two or more corporations in which the holders of

stock of both corporation would be added together in addition to retained earnings, assets and liabilities. A pooling is just what the name implies: a union of corporations.

Treatment as a pooling of interests is determined by the following substantive factors rather than by the legal form of the combination:

- (a) substantially all of the former ownership interests should continue in the combined enterprises (The combined enterprise should be owned by the same people before and after the combination.);
- (b) the ownership interests of the surviving firms should continue substantially in proportion to their interest in the constituent firms (The ownership of the combined enterprise should be the same as the previous percentage of ownership interest.);
- (c) there should remain no significant minority interest in any subsidiary corporation (This is to follow through on the theory behind the pooling of interests method that the businesses are combining for the purpose of pooling their resources.);
- (d) a continuity of former business activities;
- (e) a continuity of management (A frequent objective in combinations is to eliminate ineffective and inefficient management, and therefore this factor does not appear to be a practical criterion for deciding on the appropriate method of accounting for a combination.); and
- (f) the relative sizes of the combining firms—none of the combining firms should be clearly dominant with more than 90 to 95 per cent of the voting interest in the combined enterprise. (This is to carry out the pooling concept that each of the firms is making a significant contribution in the combined enterprise.)⁷

In a pooling of interests the accounting treatment involves two basic differences from a purchase. The first is that the assets and liabilities of the combining enterprises are brought into the new enterprise at their book value⁸ rather than their fair market value at date of transfer. The second

substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors discussed below are present.

⁷ APB ACCOUNTING PRINCIPLES §§ 1091.04-.06.

⁸ *Accounting Terminology Bulletin No. 3*, APB ACCOUNTING PRINCIPLES suggests as a definition of *book value*:

[T]he amount shown on accounting records or related financial statements at or as of the date when the determination is made, after adjustments necessary to reflect (1) correction of errors, and (2) the application of accounting practices which have been consistently followed. *Id.* at 9522.

The term *book value* should be clearly distinguished from *adjusted basis* as used for federal income tax purposes, in that adjustments used to determine book value are not always allowed in determining adjusted basis. Treas. Reg. § 1.167(a)-7(c) (1956) provides in part:

The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of the law relating to ad-

is that the retained earnings of the corporations should be added together and reflected as a total on the books of the surviving corporation or in consolidation⁹ except for that amount that must be transferred to invested capital to reflect the proper legal capital.¹⁰

To avoid the result of decreased earnings through acquisition many conglomerates have chosen to account for acquisitions by the pooling of interests method.¹¹ This arbitrary decision may not truly reflect what has transpired. The change in asset ownership may in fact be a purchase, but because of the desire to maintain a position of continually increasing earnings with little emphasis on an expanding asset base, the pooling of interests method is used when not supported by the factors delineated previously above.

B. Accounting advantages and disadvantages of the two methods

One of the most significant advantages of the purchase method for the acquired firm is that it permits a "fresh start" with respect to its accounting. If the assets of the acquired firm are under or overvalued, they can be adjusted to a fair market value at the time of the combination and a deficit in the retained earnings of the acquired firm can be eliminated in the new combination. The purchase method is disadvantageous to the company if the fair market value of the assets is greater than the previous book value because the recording of these higher values will necessitate higher depreciation and amortization charges resulting in lower net income for several years.¹² It is assumed to be disadvantageous because it eliminates the

justments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of account reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors.

⁹ APB ACCOUNTING PRINCIPLES § 2051.02 provides that consolidated statements are used to reflect the "results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions."

¹⁰ The amount of legal capital required is controlled by the laws of the state of incorporation and is generally the par value of the shares issued or, in the cases of shares without par value, an amount determined at the discretion of the board of directors. These are minimum requirements and do not prevent the capitalization of a larger amount per share for accounting purposes. See, e.g., CAL. CORP. CODE § 1900 (West Supp. 1970); see also *Accounting Research Bulletin No. 43*, APB ACCOUNTING PRINCIPLES at 6024-25.

¹¹ See APB Proposed Opinion on Business Combinations and Intangible Assets ¶ 39 (1970).

¹² If there is evidence that goodwill is of limited duration, it should be amortized for accounting purposes by systematic charges in the income statement over the period benefited. If there is no indication that goodwill will have a limited life at the time of acquisition, then for accounting purposes it will not be written off until it becomes

retained earnings of the acquired corporation thereby reducing the combined retained earnings of the acquiring corporation after acquisition.¹³

The following advantages of the pooling of interests method have led to its popularity in business combinations: 1) The pooling of interests method avoids dilution of income per share because of the revaluation of assets which is the trademark of the purchase method. 2) It avoids the necessity of recording goodwill and other intangibles that present problems of amortization and interpretation. 3) The combining of the retained earnings of the several enterprises keeps the informal promise of the conglomerate to its shareholders, adds force to their speculative desires, and hides deficits of constituent corporations.

C. Regulatory opinions affecting accounting treatment of conglomerate mergers

1. *Proposed APB Opinion "Business Combinations and Intangible Assets"*. The American Institute of Certified Public Accountant's Accounting Principles Board (APB)¹⁴ has indicated its intention to bar mergers by the

reasonably evident that it has become a worthless asset. See APB ACCOUNTING PRINCIPLES § 5141.01-10.

This accounting treatment should be contrasted with Treas. Reg. § 1.162-14 (1958) which specifically provides that no deduction will be allowed for amortization of goodwill in the computation of taxable income, but rather that amounts should be capitalized.

¹³ See H. FINNEY & H. MILLER, *PRINCIPLES OF ACCOUNTING, INTERMEDIATES* 502-03 (6th ed. 1965).

¹⁴ The American Institute of Certified Public Accountants (AICPA) is the professional organization of practicing certified public accountants. The AICPA established the Accounting Principles Board (APB) in 1959 with the authority to formulate and promulgate accounting principles which constitute the rules which certified public accountants must follow in the preparation of financial statements. Violation of the principles of the APB may result in reprimand, suspension or expulsion from the AICPA. Although expulsion does not automatically cause the loss of a CPA license, such censure may be equally as damaging to the professional reputation of the offending individual or firm since this information would be readily available to the public. Violation of provisions of the APB ACCOUNTING PRINCIPLES as well as portions of the AICPA's Code of Professional Ethics which have been incorporated into state accountancy acts (licensing statutes) may result in the revocation of the license to practice in these states.

The Securities and Exchange Commission (SEC) has frequently been the motivating force behind the promulgation of accounting principles by the AICPA. The Securities Act of 1933 and the Securities Exchange Act of 1934 empowered the SEC to establish accounting and auditing standards to be applied to corporations which come within the purview of the Acts. The interrelationship between the SEC and the AICPA has been described as a ceding of the SEC's "working" authority to the AICPA, with a retention of the right to overrule the AICPA. Although the AICPA is restricted in its power to enforce APB Accounting Principles, it is aided by the SEC's usual practice of endorsing AICPA recommendations. The SEC issues Accounting Series Releases which are statements of its policy on technical questions. The

pooling of interests method and to require the amortization of goodwill acquired over a period not to exceed forty years.¹⁵

The final announcement of the APB is currently pending official release. The reasons behind this action by the APB are the abuses of pooling which have occurred in conglomerate situations. The pooling method has been applied where companies were totally disproportionate in size.¹⁶ It has also been applied when the stock of the acquiring company used was treasury stock recently acquired for cash or other assets, thereby making the transaction a "sham" which should realistically only be accounted for by the purchase method.¹⁷ If the Conglomerate Parent Co. acquires treasury stock with cash and then exchanges such stock to acquire Subsidiary Co., it is a "sham" to treat the transaction as a pooling when in reality the steps were merely integrated parts of a unitary plan to purchase the Subsidiary Co. In situations where the Conglomerate Parent Co. established its position in the Subsidiary Co. with cash purchases and subsequently went through a merger or other exchange of stock, the concept of "partial pooling" has

weight of authority of Accounting Series Releases is greater than AICPA pronouncements, but the SEC and AICPA are usually in agreement on major policy matters. S. A. Zeff, *A FIRST GUIDE TO THE LITERATURE OF ACCOUNTING IN FINANCIAL ACCOUNTING THEORY 2* (T. F. Keller & S. A. Zeff ed. 1964).

¹⁵ See APB Proposed Opinion on Business Combinations and Intangible Assets (1970).

¹⁶ Although none of the companies combining in a merger can be clearly dominant by controlling more than 90-95% of the voting interest in the resulting combination, there have been mergers under the pooling of interests method in which the size of the merging companies was so disproportionate that the theory upon which the method is based was not satisfied. Arthur R. Wyatt has given the following as examples of combinations involving two companies of disproportionate size:

The single combination reviewed in the 1949-52 period in which there was an exchange of less than 5% of the stock outstanding in the surviving company and for which the accounting treatment was similar to pooling accounting involved the acquisition of Trackson Co. by Caterpillar Tractor Co. in late 1951. Caterpillar acquired all of the outstanding stock of Trackson (60,000 shares) in exchange for 54,000 shares of its common stock. At the time of the acquisition Caterpillar had 3,764,480 common shares outstanding. . . . In either event the net assets would be recorded by Caterpillar at book value on Trackson's books. Accounting in this manner for assets acquired is one feature of pooling accounting.

During December, 1951 the market value of the Caterpillar stock averaged about \$49 per share. Upon this basis the value of the net assets acquired from Trackson would have been \$2,646,000. Thus, by pooling the assets at the book value on Trackson's books, the assets were accounted for as a purchase, with the market value of Caterpillar's shares used as the basis for the entry. . . .

In the 1954-56 period the greater size disparity in the pooling combinations we studied existed in the Union Carbide and Carbon Corporation (now Union Carbide Corporation) merger with Visking Corporation in 1956. Union Carbide issued 864,449 shares in exchange for all the properties and assets of Visking, or 2.8% of the shares to be outstanding subsequent to the combination. Union Carbide credited its no-par capital-stock account for the amount in the capital-stock of Visking (\$12,305,791) and credited its earned surplus with the Visking earned surplus (\$12,867,308). The book value of the net assets of Visking was \$25,173,099, and this amount became merged with the Union Carbide asset values. A. WYATT, *A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS* 28-29 (1963).

¹⁷ *Id.* at 112-13.

been applied based on the percentage of cash to stock. Conglomerate companies have given retroactive effect to pooling in their consolidated income statements resulting in increased earnings by the addition of companies which were not acquired until after the close of the last year covered by the income statement. Conglomerate companies have also created "instant earnings" by acquiring assets from Subsidiary Co. without a stepped-up basis, which they sold shortly after the acquisition thereby realizing significant gains.¹⁸ In Accounting Research Study No. 5, Professor Wyatt concludes that a business combination "is basically an exchange event in which two economic interests bargain to the consummation of an exchange of assets and/or equities."¹⁹ Applying this definition, most combinations are purchases and should be accounted for as such.

The limitation of the use of the pooling method and mandatory amortization of goodwill arising from acquisition are essential steps needed to curb the impetus of that conglomerate growth which is based on unsound financial and business purposes.

2. APB Opinion No. 15 "Earnings per Share"

Since a stockholder thinks in terms of the number of shares he owns or plans to buy or sell, reducing corporate financial information to per-share terms puts it in a useful perspective. Perhaps the most commonly used statistics relating to common stock are earnings per share and dividends per share. These statistics appear widely in financial press releases, prospectuses, proxy material, and reports to stockholders.

Although earnings per share is a highly significant summary figure, it has some serious limitations and there are some dangers in focusing too much attention on this single index of performance. The manner of computing and reporting earnings per share has been of major concern not only to the accounting profession but also to the SEC and the major stock exchanges.²⁰ In 1969, the Accounting Principles Board issued Opinion No. 15, "Earnings per Share", which sets forth guidelines for reporting this statistic.²¹ The Opinion mandatorily requires that earnings per share should be shown on the face of the income statement for (a) income before extraordinary items, (b) net income, and (c) if material, earnings per share for extraordinary items. The extent of the data to be presented and the captions used will vary with the complexity of the company's capital structure.²²

Simple capital structures of corporations consist of common stock excluding

¹⁸ *Id.* at 93.

¹⁹ *Id.* at 104.

²⁰ See Acctg. Series Release No. 105, 4 CCH FED. SEC. L. REP. ¶ 72,127 (SEC 1966).

²¹ *Opinion No. 15*, APB ACCOUNTING PRINCIPLES at 6609.

²² *Id.* at 6611, ¶¶ 12, 13.

potentially dilutive convertible securities, options, warrants or other rights that upon conversion or exercise could in the aggregate dilute earnings per share. Such corporations need only make a single presentation on the face of the income statement in terms such as "earnings per common share".²³ This disclosure requirement would require the same information as the "Earnings per share and common equivalent share" section in the Statement of Income and Retained Earnings in the Appendix.

Complex corporate capital structures are illustrated at the bottom of the Financial Statements in the Appendix. Such corporations should present two types of earnings per share data with equal prominence on the face of the income statement. The first presentation of "Earnings per share and common equivalent share" is the computation of primary earnings per share based on the outstanding common shares and those securities that are in substance equivalent to common shares thereby having a diluent effect. The second presentation of "Earnings per common share—assuming full dilution" is a pro-forma presentation which reflects the dilution of earnings per share that would have occurred if all contingent issuances of common stock that would reduce earnings per share had taken place at the beginning of the accounting period.²⁴

To illustrate the significance of the earnings per share statistic, assume Conglomerate Parent Co. (C) acquired Subsidiary Co. (S) for 1,000 of C's shares, giving S's stockholders a market value improvement of approximately \$5,600 (\$236,000 total market value of C's shares after distribution less \$230,400 market value of S's shares given in exchange. See Appendix). The reason for this is that financial investors value stock as a multiple of earnings per share.²⁵ The fair market value of C's stock was a multiple of 34 times earnings and S's was only 13.6 times earnings (See combined statement of income and retained earnings in Appendix.) The tendency of investors to continue valuing S at the same multiple as C results in an increased market value based on the differences in previous multiples times the additional earnings contributed by S (20.4 x \$16,900 Subsidiary Co.'s earnings). Having created a record for growth of earnings per share through this market phenomenon, conglomerates are under pressure to maintain their growth in earnings per share by future acquisitions having the same effect.

²³ *Id.* at 6611-12, ¶ 14.

²⁴ *Id.* at 6612, ¶ 15.

²⁵ Investors rely on corporations' annual reports and SEC reports to ascertain earnings per share as a basis for valuing the stock of the corporation. If full disclosure were required in these reports as to the composition of earnings per share after acquisition this might reduce the effect of the inflated earnings per share multiple valuation of stock after a merger.

3. *Proposed APB Opinion "Changes in Accounting Methods and Estimates"*

Generally accepted accounting principles provide numerous ways of treating items of expense.²⁶ Changes in these methods made soon after the acquisition of a company by a conglomerate could boost future earnings. These methods which affect net income and earnings per share are matters within the discretion of corporate management. The relevant decisions to be made are as follows:

- a. the depreciation period of a fixed asset;
- b. whether to amortize goodwill, and if so, over what period;
- c. what method of depreciation should be used; and
- d. whether to capitalize or charge off to expenses research and development costs, costs of opening new plants, and costs of establishing foreign operations.²⁷

Considering the significant effect which can be created by a change in the method of treating expense items after a merger, it seems necessary to establish better disclosure requirements governing the preparation of financial statements regarding the actual affect of the different methods available. The proposed APB Opinion would require full disclosure of the nature of a change in accounting and its effect on net income and earnings per share for the current and prior affected accounting periods to enhance comparability of financial statements.²⁸

4. *APB position on divisional reporting.*

By using consolidated financial statements²⁹ conglomerates have not adequately disclosed informaton with respect to the nature and impact of the operations of specific divisions within the combined enterprise. Investors have relied on expectations of continued growth based on their analysis of the consolidated financial statements. Obviously the information as to divisional operations might be quite different and the investors should be made aware of the essential details in order to intelligently conduct their investment decisions. The need of investors, creditors, representatives of regulatory agencies, financial analysts, and labor union leaders for this supplemental financial statement information must be weighed against the effect on the business of disclosing such valuable information in order to achieve the

²⁶ APB ACCOUNTING PRINCIPLES § 520.03.

²⁷ If management makes an election as to the particular accounting treatment of an item, this choice does not necessarily control for tax purposes. Only certain sections of the Internal Revenue Code require that the same method used for accounting records must also be used for tax purposes. See, e.g., INT. REV. CODE OF 1954, §§ 453, 472; Treas. Reg. §§ 1.453-1(f) (1958), 1.472-2(h) (1961). See also H. FINNEY & H. MILLER, *supra* note 13, at 500.

²⁸ APB Proposed Opinion on Changes in Accounting Methods and Estimates (1970).

²⁹ See note 9 *supra*.

delicate balance which provides full and fair disclosure of the results of conglomerate operations.

Problems arise in implementing supplementary disclosure requirements because of the difficulty of establishing standards which would achieve the proper balance of reporting in such a myriad of different factual circumstances. The APB feels that further experience, research and study are necessary in order to have an adequate basis for promulgating an opinion.³⁰

Currently there is an increasing trend of companies voluntarily making disclosure of the following specific supplementary information:

- (a) Revenues by industry activity, or type of customer
- (b) Revenues and profits by separable industry segments
- (c) Separate financial statements of segments of the business which operate autonomously and employ distinctly different types of capital structure, such as insurance or bank subsidiaries of merchandising or manufacturing companies
- (d) Revenues by type of industry activity and type of customer, together with a general indication of the profitability of each category
- (e) Information that the operations of a segment of the enterprise are resulting in a loss, with or without disclosure of the amount of such loss.³¹

The disclosure of this type of supplemental information appears necessary in order to present financial statements which fairly reflect the operations of diversified conglomerates, and provide a reliable basis for investment decisions.

II. TAX CONSIDERATIONS SPECIFICALLY RELATED TO CORPORATE ACQUISITIONS

Corporate acquisitions, especially conglomerate mergers, are planned with a definite objective in mind. Whether called a purchase or a pooling, one corporation seeks to acquire another. The mechanics of the transaction have been considered in the first part of this comment. But now we must look at the transaction with a view to the silent partner of corporate mergers, the Internal Revenue Service.

The Internal Revenue Code of 1954 (Code) is replete with sections that may serve as an impetus or an obstacle, depending upon what the acquiring corporation gives up in exchange for the acquired company.

The basic items of barter are assets, promises to pay assets in the future, commonly referred to as corporate indebtedness, and stock in the acquiring corporation.

If the shareholders of the acquired company receive money or other assets in exchange for their ownership interests, they are subject to capital

³⁰ Disclosure of Supplemental Financial Information by Diversified Companies, APB ACCOUNTING PRINCIPLES § 2061.

³¹ *Id.* at § 2061.12.

gains taxation at the date of transfer.³² The same is true if the corporation which is the object of the transaction, exchanges its assets for money or other assets of the acquiring corporation.³³ This transaction may easily lead to the dissatisfaction of all parties involved. The acquiring corporation may not want, or be able, to give up any of its assets in exchange for control of the acquired company. The owners of the involved corporations, and possibly the corporations themselves may wish to escape taxation at the date of transfer.

The second method does not offer any real advantages to the owners of the acquired company. If they accept corporate indebtedness in exchange for their stock or for the assets of their corporation, they have exchanged property within the definition of the Code.³⁴ Income represented by interest on this indebtedness, when received by the shareholders, will be taxed as ordinary income. In the Tax Reform Act of 1969 (Act)³⁵ some of the advantages available to the shareholders of the acquired company using this method were eradicated.³⁶

In both the above methods the new basis of the acquired property would be the amount paid which in most situations would approximate the fair market value of the property received.³⁷ These transactions are excellent for the acquiring corporation. It receives stock or assets of the acquired company and in most instances, will have no taxable gain or loss, because it acquires the property at value given, not value received. It becomes obvious that the acquiring corporation not only may enter into a transaction of this type without fear of purchasing an income tax liability, but also may acquire a tax write off in situations where it gives up corporate indebtedness. The interest paid on the certificates of indebtedness is an ordinary and necessary expense of the acquiring corporation and is deductible.³⁸ The acquiring corporation may even "sweeten" a bond offering with a conversion feature. This means that the holder of the bond or bonds may, at some date in the future, exchange his bonds for stock in the acquiring corporation. In terms of risk, the owners of the acquired company have achieved the best possible financial position other than a direct acquisition financed by stock or assets. If the owners of the acquired company seek financial security they must weigh it against the tax disadvantages of these transactions.

The third method, stock of the acquiring corporation in exchange for the stock or assets of the acquired company, is much more desirable from a tax

³² INT. REV. CODE OF 1954, § 1201(b).

³³ *Id.* § 1201(a).

³⁴ *Id.* § 1001; Treas. Reg. § 1.1002-1 (1957).

³⁵ Pub. L. No. 91-172, 83 Stat. 492.

³⁶ INT. REV. CODE OF 1954, § 453(b)(3) (I.R.C. CCH 1970 STAND. FED. TAX REF.) [hereinafter referred to as CCH 1970].

³⁷ INT. REV. CODE OF 1954, § 1012.

³⁸ *Id.* § 163.

viewpoint. Under Section 368 of the Code, corporate acquisitions that involve the giving up of stock by the acquiring corporation are generally considered to be tax free reorganizations. The types of mergers delineated in Section 368 are, by now, old friends. They are:

- A. The statutory merger or consolidation. A merger is A and B joining to form C. A consolidation is A and B joining to form a reorganized A or B.³⁹ These are the Code's definition of a true pooling of interests.
- B. The stock for stock merger is the exchange of an acquiring company's stock for the stock of the acquired company.⁴⁰ This necessitates an exchange between the acquiring corporation and the individual shareholders of the acquired company. When the transaction is complete, the acquiring corporation may operate the acquired company as a division, or, as the majority stockholder, vote to have a liquidation and distribute the assets to itself. Of course the minority stockholders, if there are any, must receive fair compensation upon liquidation. But the acquiring corporation has achieved its objective, control⁴¹ of the acquired company. This method is most commonly used when the management of the target corporation is not as desirous as that of the acquiring firm, for a corporate takeover. If the target management is amenable to acquisition then the next method listed is preferable.
- C. The stock for assets merger. Here the acquiring firm exchanges its stock for the assets of the acquired company.⁴² The result of this transaction, involving indirect shareholder participation is the continued existence of the acquired company as a separate entity, owning as its sole assets the stock of the acquiring corporation. Generally,

³⁹ INT. REV. CODE of 1954, § 368(a)(1)(A) defines an "A reorganization" as "a statutory merger or consolidation."

Treas. Reg. § 1.368-2(b) (1955) defines *statutory merger or consolidation* as "a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia."

⁴⁰ INT. REV. CODE of 1954, § 368(a)(1)(B) defines a "B reorganization" to be:

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

⁴¹ INT. REV. CODE of 1954, § 368(c) defines *control* as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

⁴² INT. REV. CODE of 1954, § 368(a)(1)(C) defines a "C reorganization" to be:

[T]he acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded.

the acquiring corporation will enter into a liquidation shortly after the transfer and exchange its new assets for its outstanding shares. By this indirect method, the acquired corporation obtains the assets of the target company, and the target stockholders receive an ownership interest in the acquiring corporation. This situation is preferable in that it allows the exchange without leaving the unwanted minority shareholders and circumvents a problem that cannot be consistently avoided in the direct stock for stock transfer. If the acquiring corporation gives up more than stock, such as assets or corporate indebtedness, then the transaction will result in being partially non-taxable to the shareholders of the acquired company.⁴³ There are other requirements, in addition to a stock transfer that effect the taxability of the transaction. There are many variables which, although unimportant to the thrust of this discussion, will make a large difference in the initial decision to make an acquisition. Included among these are the type of securities the shareholders of the acquiring corporation wish to exchange, if the acquired company has a net operating loss⁴⁴ and what benefit, if any, the acquiring corporation can make of this tax loss.

Furthermore, in a nontaxable acquisition there would be no immediate tax liability to the seller from its disposition of Section 38,⁴⁵ Section 1245⁴⁶ and Section 1250⁴⁷ property although the potential tax liability from recapture of credit and ordinary income potential from disposition of depreciable property will carry over to the acquiring corporation. In a taxable acquisition, computation of tax liability at ordinary rates would be required under Sections 38, 1245 and 1250. This additional tax liability could be shifted either to the acquiring corporation or to the acquired company, depending on the steps which are to take place in the transaction.

A conglomerate merger is a taxable event if effected by financing the purchase price of the acquisition with cash, or with a cash downpayment and the balance with promissory notes, or with part cash and part stock, or with nonvoting stock or debt securities. The taxable effect of the acquisition is the recognition of gain or loss by the acquired company and the receipt of a stepped-up basis in acquired assets by the acquiring corporations.⁴⁸

When the expectations of the owners and management of the target company, and the regulations of the IRS are considered in juxtaposition to

⁴³ J. CHOMMIE, *FEDERAL INCOME TAXATION* 495 (1968) states that:

[A]s a general rule, if property (boot) other than stock or securities is received, sections 356(a) and (b) preserve the tax-free character of the exchange but subject gain realized to tax to the extent of the value of the boot.

⁴⁴ INT. REV. CODE OF 1954, § 172.

⁴⁵ See *id.* § 38.

⁴⁶ See *id.* § 1245.

⁴⁷ See *id.* § 1250.

⁴⁸ *Id.* §§ 1012, 1201.

the desired results of the owners and management of the acquiring corporation, one must be impressed at the high level of corporate mergers. How so many people, and so many competing factors can be compromised to achieve the fantastic growth rate of the conglomerate, boggles the mind and causes the senses to reel.

Tax considerations based on the Tax Reform Act of 1969.

1. Debt financed corporate acquisitions.

Even though these transactions are termed taxable, there are definite tax advantages to the acquiring corporation if it adopts the debt financed method. At the outset it must be recognized that the initial choice of acquisition, as already explained, will be negotiated between the acquirer and the acquired corporation. If for various reasons, the acquired company's management can be convinced to accept a non-taxable exchange, the acquiring corporation may benefit greatly.

Formerly the foremost benefit in a taxable exchange involving debt securities was the interest deduction as opposed to non deductible dividends on outstanding stock.⁴⁹ By issuing corporate indebtedness the acquiring corporation increases its retained earnings after taxes by reducing its taxable income. The IRS has thereby become a party in these transactions. The bonds given may be convertible to preferred or common stock of the acquiring corporation. In 1969 the Federal Government enacted the following provisions which directly restrict its participation in these taxable acquisitions.

Issuance of convertible bonds in an acquisition gives the holder the right to exchange or convert his bond into stock under stipulated conditions. The advantage to the issuing corporation is that it induces the bond holder to accept a lower rate of interest or it may enhance an otherwise unmarketable issue. Moreover, the corporation enjoys a reduction of fixed charges and an increase in credit rating if the debt is converted into common stock. The holder who cannot or will not assume the risks of stock ownership can realize his profit by selling his bonds when, and if, their price rises because of the increase in the value of the stock for which it is convertible.

The principle reasons for using bonds rather than stock to finance an acquisition are:

(1) Bonds may be the only available source of funds. Many businesses are so impermanent as to make permanent ownership investment risky and impractical for outsiders. (2) To lower the cost of the funds. Because bonds represent less investment risk than stocks, a corporation might sell bonds at a lower rate than would be necessary to induce investors to buy stocks. (3) Tax advantage in debt financing. Interest charges—but not dividends—are deductible in computing the amount subject to income taxes.⁵⁰

⁴⁹ See *id.* § 163.

⁵⁰ H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 165 (4th ed. 1962).

The Act⁵¹ contains significant provisions affecting the use of convertible debentures in the conglomerate merger area. These provisions are aimed at tax benefits currently enjoyed by parties involved in acquisitions financed in whole or in part by convertible bonds. The Act limits the acquiring corporation's interest deduction on such bonds and prevents a stockholder in the acquired company from electing installment reporting in an attempt to defer gain realized on the transaction to a later year.

(a) *Disallowance of interest deduction on indebtedness incurred by a corporation to acquire stock or assets of another corporation.* The Act adds a new Section 279⁵² to the Code which limits the interest deduction of large acquisition programs which generate "corporate acquisition indebtedness" and which meet four statutory tests.⁵³ To the extent the interest on such indebtedness exceeds five million dollars, as adjusted by the Code for any taxable year, the excess will be disallowed as a deduction.⁵⁴ This Section is aimed at very substantial acquisitions where the obligations issued closely resemble equity instruments.

Section 279 will have limited application because a number of corpora-

⁵¹ Pub. L. No. 91-172, 83 Stat. 492.

⁵² INT. REV. CODE OF 1954, § 279 (CCH 1970).

⁵³ The standard for *corporate acquisition indebtedness* is defined as any obligation whether directly or indirectly as in guaranty or by assumption which:

(1) is issued as a consideration for stock or at least two-thirds of the value of all the assets, except money, used in the acquired corporation's trade or business;

(2) is either:

(A) subordinated to the claims of the several trade creditors of the acquiring corporation, or
(B) expressly subordinated to "any substantial amount of unsecured indebtedness." It is not material as to whether this indebtedness is outstanding at the time of the questioned acquisition or is subsequently issued.

(3) is either:

(A) convertible into stock of the acquiring corporation, or
(B) part of an "investment unit or other arrangement" which includes an option to acquire stock in the acquiring corporation.

(4) is issued by a corporation and as of the end of the taxable year in which the obligations are issued, either:

(A) the ratio of debt to equity of the corporation exceeds 2 to 1, or
(B) the average annual earnings of the corporation computed with certain adjustments for their three-year period ending with the year of acquisition do not exceed 3 times the annual interest to be paid by such acquiring corporation. The two tests of this part are applied to the combined earnings and indebtedness of both the acquired and acquiring corporations if the acquiring company obtains 80% control, as defined in Internal Revenue Code § 368(c), of the stock of the acquired corporation or substantially all of its assets. For the purpose of this last test special rules apply to financial institutions. *Id.* § 279(b).

⁵⁴ The Act provides for a limitation on the amount of interest deduction allowed with respect to its corporate acquisition indebtedness:

to the extent that such interest exceeds—

(1) \$5,000,000, reduced by

(2) the amount of interest paid or incurred by such corporation during such year on obligations (A) issued after December 31, 1967, to provide consideration for an acquisition described in paragraph (1) of subsection (b), but (B) which are not corporation acquisition indebtedness. *Id.* § 279(a).

tions will never issue enough indebtedness to exceed the five million dollar limit and further, because many of the corporations which were large enough to be concerned with that test would, in the normal course of business, issue obligations which fail one of the four tests for determining "corporate acquisition indebtedness".

Once an obligation reaches the Section 279 limitation, its interest will continue to be disallowed as a deduction in all subsequent years in which the five million dollar limit is exceeded unless in a later year one of the two exceptions is met. The first exception contemplates an additional transaction whereby control of a subsidiary is acquired by the parent company. The second exception requires that the fourth test⁵⁵ must be met for three consecutive years, thus affording relief only at the beginning of the fourth year.⁵⁶

Section 279 is applicable to interest on indebtedness incurred after October 9, 1969. It does not apply to obligations existing prior to that date which are subsequently refinanced or extended or to acquisitions of stock in a corporation which was at least 50 per cent controlled by the acquiring corporation on that date.⁵⁷

Assume Conglomerate Parent Co. issues 6 per cent debentures in consideration for 80 per cent of the common stock of Subsidiary Co. on March 27, 1970. The bonds are subordinated to other creditors and convertible into the stock of the Conglomerate Parent Co. On December 31, 1970, Conglomerate Parent Co. has a total indebtedness of \$60 million and equity of \$30 million. Its ratio of debt to equity is two to one and does not exceed the statutory limit under the fourth test. Conglomerate Parent Co.'s average annual earnings for the preceding 3 year period are \$40 million and its annual interest costs are \$5 million. Subsidiary Co.'s average annual earnings for the same period are \$10 million and its annual interest costs are \$4 million. As of the year end of the acquiring company which is the date for applying the test, Conglomerate Parent Co.'s projected combined average annual earnings of \$50 million do not exceed three times the combined annual interest costs of \$27 million. Thus the bonds issued meet the earnings test. Since all four tests are met, the bonds constitute "corporate acquisition indebtedness" and the interest deduction on these debentures will be limited to five million dollars annually unless the tests are not met in future years.

(b) *Limitations on Installment Sales.* Under prior law stockholders of a corporation acquired in a conglomerate merger could receive convertible bonds and defer payment of tax on the resulting gain until they disposed of the debentures, collected a portion of the principal, or the debentures were retired. This was accomplished by electing the installment method of re-

⁵⁵ See test (4) in note 53 *supra*.

⁵⁶ INT. REV. CODE OF 1954, § 279(d)(3), (4) (CCH 1970).

⁵⁷ *Id.* § 279(h), (i).

porting gain under the requirements of Code Section 453(b).⁵⁸

The Act provides that a taxpayer will no longer be able to use the installment method when the debt obligation received is "a bond or other evidence of indebtedness which is payable on demand," and readily marketable in an established securities market. This new definition provides that:

a bond or other evidence of indebtedness which is payable on demand or which is issued by a corporation or a government or political subdivision thereof A) with interest coupons attached or in registered form, or B) in any other form designed to render such bond or other evidence of indebtedness readily tradeable in an established securities market, shall not be treated as an evidence of indebtedness of the purchaser.⁵⁹

The phraseology of the new Section 453(b)(3) specifically states that evidences of indebtedness will not be treated as payments in the year of sale. The stockholders of the acquired company may still qualify to elect the installment method even though the acquiring corporation issues obligations payable on demand, in registered form, or with coupons attached, provided that the obligations are *issued* in a taxable year following the year of sale.

Assume a stockholder of Subsidiary Co. sells stock with a two thousand dollar basis to Conglomerate Parent Co. for six thousand dollars of its 6 per cent bonds, redeemable in twenty years. The stockholder realizes a four thousand dollar gain on the sale but under prior law could defer recognition of the gain until the bonds were redeemed by electing the installment method of reporting. The bonds are treated as "evidences of indebtedness" under prior law and not subject to the thirty per cent receipt in the year of sale test imposed by Code Section 453. The Act provides that bonds

⁵⁸ INT. REV. CODE OF 1954, § 453(b) provides:

SALES OF REALTY AND CASUAL SALES OF PERSONALTY.—

(1) GENERAL RULE.—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding \$1,000, may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 per cent of the selling price.

(B) In the case of a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was (by reason of section 44(b) of the Internal Revenue Code of 1939) returnable on the basis and in the manner prescribed in section 44 (a) of such code.

For specific examples of use of the installment provisions in negotiating acquisitions see Holden, *The Background of Some Recent Mergers and Acquisitions*, 27 INSTITUTE ON FEDERAL TAXATION 885, 887-91 (1969).

⁵⁹ INT. REV. CODE OF 1954, § 453(b)(3) (CCH 1970), amending INT. REV. CODE OF 1954, § 453.

are not to be treated as "evidences of indebtedness", and thus are included in applying the thirty per cent test disqualifying the transaction from treatment as an installment sale. The possibility of deferring issuance of bonds to the taxable year following the year of sale, might provide a loophole for the stockholder to conform with the Code Section requirements for electing the installment method of recognition. It should be noted that the IRS has not yet promulgated regulations under this new provision and such regulations might construe the provision as preventing the use of the deferred issuance device.

(c) *Original issue discount.* Under prior law, if the sale or exchange of an obligation issued by any corporation, government, or political subdivision, held by the taxpayer for more than six months resulted in gain, it would be treated as ordinary income to the extent of:

- (1) the original issue discount on the obligation, less
- (2) the original issue discount multiplied by the following fraction if, at the time of the original issue, there was no intention to call the obligations before maturity:

$$\frac{\text{Number of complete months the obligation was held by the taxpayer}}{\text{Number of complete months from date of original issue to the date of maturity.}^{60}}$$

Any gain realized in excess of that treated as ordinary income is recognized as long term capital gain.

The term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. Moreover, the discount is considered to be zero, if the original issue discount is less than $\frac{1}{4}$ of 1 per cent of the redemption price at maturity multiplied by the number of complete years to maturity.⁶¹

The Act provides that the holder of a bond, debenture, or other evidences of indebtedness issued by a corporation will be required to include in gross income a ratable portion of "original issue discount" for the period he holds such evidence of indebtedness.⁶² The purpose of this change is to require the holder to include original issue discount in income on the same basis that the issuing corporation claims a deduction. The Act also provides that the same provisions of the prior law will still be applicable to government obligations issued at any time and corporate obligations issued before May 28, 1969.⁶³ Where evidences of indebtedness are issued as an investment unit, the issue price of each will be the amount of the total issue price allocated to each element of the investment unit proportionate to its relative fair market value on the date of issuance.⁶⁴

⁶⁰ INT. REV. CODE OF 1954, § 1232(a)(2).

⁶¹ *Id.* § 1232(b)(1).

⁶² INT. REV. CODE OF 1954, § 1232(a)(3) (CCH 1970), amending INT. REV. CODE OF 1954, § 1232(a).

⁶³ *Id.* § 1232(a)(2)(B), amending INT. REV. CODE OF 1954, § 1232(a).

⁶⁴ *Id.* § 1232(b)(2), amending INT. REV. CODE OF 1954, § 1232(b).

To illustrate the effect of the new provision, assume that on November 1, 1970, an individual purchased an original issue of Conglomerate Parent Co.'s ten year 6 per cent debentures for \$88,000 with a stated redemption price of \$100,000. Interest is payable semiannually on January 1 and July 1. There was no intention of calling the bonds at the time they were issued. The ratable amount of the "original issue discount" that the individual must include in his gross income until the bond is sold, exchanged, or redeemed will be \$100.⁶⁵ For 1970 the individual must include \$200⁶⁶ of original issue discount in income even though he has not received an interest payment from Conglomerate Parent Co. For 1971 the individual must include \$1,200 of the original issue discount and the \$6,000 of interest received in gross income.

Furthermore, on July 1, 1972, assume the individual sells Conglomerate Parent Co.'s debentures to another individual for \$95,000. The ratable amount of original issue discount that must be included in the buyer's gross income each month will be \$50.⁶⁷

If similar debentures had been issued on November 1, 1968 prior to the effective date of the Act, the first holder would include in gross income only the actual interest paid, or constructively received during his taxable year. In the year of sale, in addition to reporting his interest income as of the date of the sale, the holder would also include the original issue discount of \$100 times the number of complete months he held the debentures. The individual purchasing the debentures would include in gross income the actual interest paid or constructively received.

(d) *Limitation on deduction of bond premium on repurchases.*

In *Roberts & Porter, Inc. v. Commissioner*,⁶⁸ the Seventh Circuit held that premiums paid by the taxpayer corporation in excess of the amount which it was legally bound to pay when it called its convertible notes were deductible as ordinary and necessary business expense under Code Section 162.

The call premium is the amount of the excess of the repurchase price of convertible debt over the "adjusted issue price" the issue price which has

⁶⁵ $\frac{1 \text{ month}}{120 \text{ months}}$ times \$12,000.

⁶⁶ The bondholder must include \$100 for each full month he holds the obligation (\$1200 per year) plus the stated interest on the bonds. (6% x \$100,000 redemption price equals \$6,000 per year.) Thus the total amount of interest income when the bonds are held for a full year would be \$7,500.

⁶⁷ $\frac{1 \text{ month}}{100 \text{ months}}$ times \$5,000 which is the selling price less the original issue price,

and less the \$2,000 discount previously included in the seller's gross income.

⁶⁸ 307 F.2d 745 (7th Cir. 1962).

been adjusted to reflect the original issue discount amortized over the life of the bond which was originally deducted from income and any premium originally reported as income.⁶⁹

The position of the IRS⁷⁰ was that a deduction for premiums paid by a corporation on the redemption or repurchase of its own bonds is limited to an amount which relates to the cost of borrowing money and any excess amounts are not deductible. This ruling is contrary to the decision in *Roberts & Porter, Inc.* The new Code Section 249(c) specifically provides that no inference shall be drawn as to the deductibility of a call premium on convertible debt repurchased prior to April 23, 1969⁷¹ thus it may be argued that the decision in *Roberts & Porter, Inc.* is the correct interpretation of the law applicable to repurchase of convertible debt prior to April 23, 1969. If correct, this means a corporation could fully deduct the call premium on convertible debt repurchased prior to April 23, 1969.

The purpose of the new Section is to settle the controversy as to deductibility of call premiums on convertible debt repurchased after April 23, 1969 and to prevent deductions for payments which are really capital in nature. The Act provides that no deduction will be allowed a corporation for a premium paid to repurchase its own convertible debentures unless it can establish that the premium represents the cost of borrowing. The deduction, if allowed, is the amount of adjusted issue price plus a normal call premium on debt which is not convertible.⁷²

2. Multiple corporations

Conglomerates have found it advantageous to operate as a group of corporations for the purpose of meeting various provisions in the Code. The intent of Congress in establishing per corporation limits in certain sections of the Code was to apply limits on individual corporations and not to entitle large companies to operate as a group of corporations for the purpose of obtaining multiple tax benefits.

Under prior law a "controlled group" of corporations was required either to apportion among its members a single surtax exemption or to elect multiple surtax exemptions and pay an additional tax of 6 per cent on the first \$25,000 of taxable income of each corporation.⁷³ Suppose Conglomerate Parent Co. was operating a group of nine subsidiary corporations. Under prior law the group could elect to have each corporation take a \$25,000 surtax exemption and pay an additional tax of 6 per cent. This would result in \$250,000 of surtax exemptions for the group which would be taxed at

⁶⁹ INT. REV. CODE OF 1954, § 249(b)(1) (CCH 1970).

⁷⁰ Rev. Rul. 409, 1967-2 CUM. BULL. 62.

⁷¹ INT. REV. CODE OF 1954, § 249(c) (CCH 1970).

⁷² *Id.* § 249(a).

⁷³ INT. REV. CODE OF 1954, § 1561-63.

28 per cent tax rate, rather than one \$25,000 surtax exemption taxed at a 22 per cent tax rate and the balance of the taxable income of the group taxed at a 48 per cent tax rate. The net tax savings on electing multiple surtax exemptions for our hypothetical group of ten corporations was \$43,500. Similar tax advantages accrue from multiple application of the provisions for accumulated earnings tax, the small business deduction for life insurance, investment credit, and additional first year depreciation.

The Act repeals the right of a "controlled group"⁷⁴ to elect multiple surtax exemptions and provides that each group will be entitled to only:

- (1) *Surtax Exemption*—one \$25,000 exemption under Section 11(d).
- (2) *Accumulated Earnings Tax*—one \$100,000 amount for purposes of

⁷⁴ INT. REV. CODE of 1954, § 1563(a) defines *controlled group of corporations* to mean any group of—

(1) PARENT-SUBSIDIARY CONTROLLED GROUP.—One or more chains of corporations connected through stock ownership with a common parent corporation if—

(A) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and

(B) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

(2) BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsection (d)(2)) by one person who is an individual, estate, or trust.

(3) COMBINED GROUP.—Three or more corporations each of which is a member of a group of corporations described in paragraph (1) or (2), and one of which—

(A) is a common parent corporation included in a group of corporations described in paragraph (1), and also

(B) is included in a group of corporations described in paragraph (2).

(4) CERTAIN INSURANCE COMPANIES.—Two or more insurance companies subject to taxation under section 802 which are members of a controlled group of corporations described in paragraph (1), (2), or (3). Such insurance companies shall be treated as a controlled group of corporations separate from any other corporations which are members of the controlled group of corporations described in paragraph (1), (2), or (3).

The Tax Reform Act of 1969 has amended § 1563(a)(2) to read:

"(2) BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

"(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

"(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation."

INT. REV. CODE OF 1954, § 1563(a)(2) (CCH 1970).

computing the accumulated earnings credit under Section 535(c)(2) and (3).

- (3) *Small Business Deduction for Life Insurance*—one \$25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under Sections 804 and 809.⁷⁵
- (4) *Investment Credit*—new property limited to the group's aggregate tax liability up to \$25,000 plus 50 per cent of the tax liability above \$25,000; and old property limited to a maximum of \$50,000 apportioned as to the amount of used property held by each member of the "controlled group."⁷⁶
- (5) *Additional First Year Depreciation*—limited the additional first year depreciation deduction to 20 per cent of qualified property in the year acquired up to an aggregate cost of \$10,000 per year under Section 179(d).⁷⁷

The effective date of this change is December 31, 1974.⁷⁸ The Act also provides for a six year transition period for converting to the new limitations on a gradual basis.⁷⁹

CONCLUSION

The changes in financial reporting effected by the APB Opinions will provide fuller disclosure of conglomerate operations to creditors, investors, representatives of regulatory agencies, financial analysts, and labor union leaders. Such disclosure will curtail the conglomerate's use of reporting techniques which simulate an increase in earnings without relating the source of such increase. An implication should not be drawn from this analysis that all the increases in earnings reported by conglomerates are based upon manipulations in financial reporting. Many conglomerates have shown phenomenal growth from their operations without manipulating the reporting techniques employed. It is the duty of the accounting profession to see that the company's operations are fairly reflected by the reported financial statements.

The Act eliminates the tax benefits available in certain conglomerate acquisitions but does not modify provisions relating to tax free reorganizations. The Act focuses on acquisitions financed by convertible debentures which are really equity securities. Thus the scope of application of this new debt-acquisition provision is quite limited and does not fully implement the proposed intent of the legislature. However, the changes affecting the operation of multiple corporations are broader in scope. The definition of a "controlled group" has been greatly expanded to

⁷⁵ *Id.* § 1561(a)(3).

⁷⁶ *Id.* §§ 46(a), 48(c)(2)(C).

⁷⁷ *Id.* § 179.

⁷⁸ *Id.* § 1564(a)(2).

⁷⁹ *Id.* § 1564(a)(1).

reach corporations which were not previously included. The provisions establish new limitations for the application of surtax exemptions, accumulated earnings tax, the small business deduction for life insurance, investment credit, and additional first year depreciation. This severely affects the tax advantages of the operations of most "controlled groups".

Although the accounting and tax developments will significantly affect the rate of conglomerate growth, the structural trend in this area will continue based on economic and financial factors as the primary impetus.

Joanne S. Rocks

APPENDIX

BALANCE SHEET

As of December 1, 19--

	Conglomerate Parent Co. (C) (Acquiring Co.) (Acquired Co.)	Subsidiary Co. (S)	Surviving Co. Merger Accounted For As POOLING PURCHASE
Current Assets:			
Cash	\$ 200,000	\$ 15,000	\$ 215,000
Marketable Securities, at lower of cost or market	10,000	2,000	12,000
Accounts Receivable, net of allowance for doubtful accounts	1,000,000	100,000	1,100,000
Inventory	50,000	30,000	80,000
	<u>\$1,260,000</u>	<u>\$147,000</u>	<u>\$1,407,000</u>
Fixed Assets:			
Land, at cost	\$ 200,000	\$ 50,000	\$ 260,000 (1)
Buildings, net of allowance for depreciation	700,000	28,000	733,600 (1)
Machinery and Equipment, net of allowance for depreciation	500,000	22,000	526,400 (1)
Goodwill			23,000
Total Assets	<u>\$2,660,000</u>	<u>\$247,000</u>	<u>\$2,950,000</u>
Liabilities:			
Accounts Payable	\$ 230,000	\$ 60,000	\$ 290,000
Convertible Bonds, 5%, 800 authorized, issued, and outstanding each bond convertible into 10 shares of common stock	800,000		800,000
Total Liabilities	<u>\$1,030,000</u>	<u>\$ 60,000</u>	<u>\$1,090,000</u>
Stockholders' Equity			
6% Cumulative, Non-participating Preferred Stock, \$80 stated value, 5,000 shares authorized, issued and outstanding	\$ 400,000		\$ 400,000
Common Stock, \$100 par value, 10,000 shares, 1,200 shares; and 11,000 shares, respectively, authorized, issued, and outstanding	1,000,000	\$120,000	\$1,100,000(2)
Capital in Excess of Par Value	230,000	67,000	20,000
Retained Earnings	<u>\$1,630,000</u>	<u>\$187,000</u>	<u>297,000</u>
Total Stockholders' Equity	<u>\$2,660,000</u>	<u>\$247,000</u>	<u>\$1,860,000</u>
Total Liabilities and Stockholders' Equity			<u>\$2,950,000</u>

(1) Fixed assets of S are recorded at fair market value which is assumed to be 20% above their cost basis.

(2) Assume issuance of C's stock at \$100 par value and \$230 fair market value.

COMBINED STATEMENT OF INCOME
AND RETAINED EARNINGS
For the Perior Ended December 31, 19--

	Conglomerate Parent Co. (C)	Subsidiary Co. (S)	Surviving Co. Merger Accounted For As POOLING PURCHASE
	(Acquiring Co.)	(Acquired Co.)	
Sales	\$4,800,000	\$520,000	\$5,320,000
Cost of Goods Sold	2,800,000	320,000	3,120,000
Gross Profit on Sales	<u>\$2,000,000</u>	<u>\$200,000</u>	<u>\$2,200,000</u>
Operating Expenses:			
Selling Expenses	\$ 800,000	\$ 80,000	\$ 880,000
General Expenses	<u>1,000,000</u>	<u>100,000</u>	<u>1,100,000</u>
	\$1,800,000	\$180,000	\$1,980,000
	<u>\$ 200,000</u>	<u>\$ 20,000</u>	<u>\$ 220,000</u>
Net Operating Income	40,000	40,000	40,000
Other Expenses:			
Interest Expense - Bonds	\$ 160,000	\$ 20,000	\$ 176,850
Income before income tax and extraordinary item	70,300	3,100	73,388
Income tax	\$ 89,700	\$ 16,900	\$ 100,100
Extraordinary item - Gain on sale of property less applicable taxes	1,900	1,900	1,900
Net income	\$ 91,600	\$ 16,900	\$ 100,362
Retained Earnings, beginning balance	182,400	72,500	175,638
Deduct Dividends:			
Common Stock @ \$2/share	\$ 274,000	\$ 89,400	\$ 343,000
Preferred Stock @ 6%	20,000	2,400	22,000
Retained Earnings, ending balance	<u>24,000</u>	<u>24,000</u>	<u>24,000</u>
	\$ 230,000	\$ 67,000	\$ 297,000
			<u>\$ 230,000</u>

(3) Increase in General Expense is due to additional depreciation based on acquired assets being recorded at fair market value, and amortization of goodwill for accounting statement presentation.

<i>Earnings per share and common equivalent share:</i>				
Income before extraordinary item	\$6.57	\$14.08	\$6.92	\$6.77
Extraordinary item	.19	<u>\$14.08</u>	.17	<u>.17</u>
Net income	<u>\$6.76</u>		<u>\$7.09</u>	<u>\$6.94</u>
Multiple of Earnings per share (This line is not required by APB#15)	34	13.6		
<i>Earnings per common share -- assuming full dilution:</i>				
Income before extraordinary item	\$3.65	\$14.08	\$4.01	\$3.92
Extraordinary item	.11	<u>\$14.08</u>	.10	<u>.10</u>
Net income	<u>\$3.76</u>		<u>\$4.11</u>	<u>\$4.02</u>

Explanatory Comments of the Financial Statements in Appendix

An acquisition accounted for as a purchase is illustrated in column 4 of the Balance Sheet and Combined Statement of Income and Retained Earnings. The purchase price is computed on the basis of a \$230 assumed fair market value of the stock being used by the acquiring corporation. The purchase price of \$230,000 is allocated among the specific intangible and tangible assets acquired, and the remainder is allocated to goodwill. This allocation normally results in recording the assets acquired from the acquired company at a basis determined by the fair market value of the asset on the date of acquisition. The Subsidiary Co. now has stock of the Surviving Co. as its only asset on its Balance Sheet after the acquisition. Operations after the acquisition, produce less net income than the same operations before the acquisition, because of the increased depreciation expense based on the higher basis of the acquired assets, and the amortization of goodwill.

As illustrated in column 3 of the same statements, the combination is reflected by the pooling of interests method. The companies pool their operations by adding their individual financial statements together. The assets of each of the constituent corporations are pooled together and recorded by the Surviving Co. at the same value they were shown as on the constituent corporations' books prior to the combination. The basis of acquired assets remain the same as in the hands of the acquired company prior to acquisition and there is no goodwill created in the transaction. The net income of the Surviving Co. consists of the combined net income of the constituent corporations.