With Special Reference To Conglomerate Acquisitions

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A CRITIQUE OF THE RULE-MAKING PROCESS IN FEDERAL INCOME TAX LAW WITH SPECIAL REFERENCE TO CONGLOMERATE ACQUISITIONS

WILLIAM D. POPKIN†

INTRODUCTION

The federal income tax law contains many detailed and confused provisions, but none have quite the same ancient lineage as the rules relating to corporate acquisitions. The law has provided an exemption for selling shareholders when corporations merge and the shareholders have retained an equity interest in the acquiring corporation since 1918.1 The deferral of tax when a sale is in exchange for debt, including a sale of stock, goes back almost as far.2 From an acquirer's point of view, the use of debt as consideration has the added attraction that interest is deductible, an old rule of general application not limited to use of debt in a purchase.3 These rules have undergone a long process of judicial, administrative and legislative changes, the latest of which

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1. The first provision appeared in the Revenue Act of 1918, § 202(b), 40 Stat. 1060. It applied to exchanges of stock and securities for stock and securities in "reorganizations, mergers and consolidations." The law had a number of irrational limitations on the investor's exemption, such as its inapplicability (1) to the excess of the par value of the stock or securities received over the par value of the stock or securities sold and (2) to transactions in which the corporation transferred assets. These limitations were removed in the Revenue Act of 1921, § 202(c) (2), 42 Stat. 230. In 1924 the transfer by the corporation transferring assets was also exempt. Revenue Act of 1924, § 203(b) (3), 43 Stat. 256. The "continuity of interest" requirement was firmly established by judicial decision in Pinellas Ice and Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). The current highly articulated version of these rules appears in INT. REV. CODE of 1954 §§ 354, 356, 361 and 368 (hereinafter all section references are to the INTERNAL REVENUE CODE of 1954 unless otherwise specified).

2. The first statutory provision appeared in the Revenue Act of 1926, § 212(d), 44 Stat. 23. Prior Treasury Regulations had allowed deferral but some Board of Tax Appeal cases had questioned their validity; S. REP. No. 52, 69th Cong., 1st Sess. 19 (1926); reprinted in, 1939-1 (Part 2) Cum. BULL. 346-47. The current provision is § 453.

3. The deduction for interest was authorized by the Revenue Act of 1913, § II G(b) (first), 38 Stat. 172, which was the general "ordinary and necessary expense" provision, now found in § 162. The deduction was subject to certain limitations found in 38 Stat. 173, § II G(b) (third), which were eliminated in the Revenue Act of 1918, § 234(a) (2), 40 Stat. 1077. The earlier limiting provision has survived in § 163 as a provision broadening the interest deduction for corporations to include capital expenditures.
deals with the use of corporate debt and derives primary impetus from Congressional antipathy towards conglomerate acquisitions. This article, a study of that process, has as its primary goal the re-examination of the way tax rules are made.

The framework for the study is the maze of rules which have special importance for conglomerate acquisitions. The first part deals with the history of tax-exempt mergers, tax-deferred sales and the treatment of original issue discount prior to the Tax Reform Act of 1969. The second part is a description and critique of changes made by the Tax Reform Act affecting conglomerate acquisitions. Part three is an analysis of the taxation of "sweeteners," such as conversion privileges, warrants and contingent stock which are often used in conglomerate acquisitions. The fourth part provides some final observations on the rule-making process and suggestions for change.

I. TAX-EXEMPT AND TAX-DEFERRED SALES AND ORIGINAL ISSUE DISCOUNT

A. TAX-EXEMPT MERGERS

The provisions of the Code exempting mergers were born at a time when the structural assumptions of the tax law were in their infancy. Two major policies explain the early legislation: (1) to encourage economically desirable business arrangements; and (2) to provide relief from taxation when the investor’s interest continued to depend on the same business risks. A third consideration which might help to explain the exemption for mergers appeared in another provision which exempted gain whenever the proceeds of the sale lacked a readily realizable market value. Although this rule remained in statutory

4. Tax Reform Act of 1969, Pub. L. No. 91-172 (hereinafter cited as Tax Reform Act), § 411 (disallowance of interest deduction on corporate acquisition indebtedness), adding § 279; § 412 (unavailability of deferral of gain under installment method for certain corporate debt), amending § 453(b); § 413 (modifying taxation and reporting of original issue discount), amending §§ 1232(a) and (b) and 6049(a)(1) and (c). See Hearings Before the House Ways and Means Committee on the Subject of Tax Reform, 91st Cong., 1st Sess. 2363-2550 (1969) (hereinafter cited as House Hearings).


6. S. Rep. No. 617, 65th Cong., 3d Sess. 5, 6 (1918), reprinted in, 1939-1 (Part 2) Cum. Bull. 120 (exchanges considered “paper transactions”). These were the days when the taxation of unrealized gains was a question of constitutional significance: Eisner v. Macomber, 252 U.S. 189 (1920). While corporate reorganizations were held to involve realized gain (United States v. Phellis, 257 U.S. 156 (1921)), there had been some administrative uncertainty on this question, the history of which is traced in R. Paul, Reorganizations, in Studies in Federal Taxation (3d Series) 8-9 (1940).

form for only three years, it is possible that the chance of receiving such property was a contributing factor in the legislation on mergers.

The development of the requirement that the shareholder continue an investment in the acquiring corporation manifests an attempt by the courts to interpret the law in light of its intended purpose, followed by a retreat into literalism which misapplied that purpose. The 1921 statute exempted the receipt of stock or securities in a "merger," which was defined to include the acquisition of stock or assets. The courts refused to apply this provision literally, and required that the securities received provide some continuity of interest. But the continuity required did not insure that the seller's risk continue to depend upon the assets acquired to any significant degree. On the contrary, the equity received did not have to represent a significant percentage of the voting or profit interest of the buying corporation; the equity could be solely non-voting and non-participating preferred. Significant amounts of debt and cash could be received as long as a "material part" of the consideration provided the watered-down continuity. Although equity without a voting or profit participation qualified a transaction for exemption, long-term debt did not provide the needed continuity. Apparently, however, debt was not the equivalent of cash in determining whether debt and equity together provided the necessary continuity.

If cash or debt (referred to as "boot") did not destroy the exemption for the equity by causing the transaction to be a taxable sale, the cash (and, since the 1954 Code, the debt under certain circumstances) was taxed as if it had the effect of a dividend for the shareholder.


13. Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935). The Service recently ruled that there is sufficient continuity if the equity received equals at least 50 per cent of the value of the transferred assets; Rev. Rul. 66-224, 1966-2 Cum. Bull. 114. The Minnesota Tea case (supra note 11 at 386) had referred to a "material part of the value of the transferred assets," not a percentage of the value of the acquired corporation.

14. LeTulle v. Scofield, 308 U.S. 415 (1940) (about 94 per cent of the consideration was long-term debt and 6 per cent cash).

15. Helvering v. Watts, 296 U.S. 387 (about 48 per cent equity and 52 per cent long-term debt sufficient continuity); the figures are derived from the courts of appeals opinion, 75 F.2d 981 (2d Cir. 1935).

16. This provision entered the law in the Revenue Act of 1924, § 203(d)(2), 43
However, since the original merger provision was confused with the exemption for exchanges of like-kind property, the amount taxed as a dividend was limited to the gain realized upon the disposition of stock in the merger.\(^{17}\)

Judgments on the amount of cash and debt on the one hand, and equity on the other, which can be received without turning the transaction into a taxable sale, are currently made in the aggregate for all shareholders. Thus, although one shareholder receives only stock, if the total consideration received by all shareholders includes excessive amounts of cash and/or debt, the transaction is a taxable sale for all shareholders. However, if the amount of cash and/or debt is not excessive, it appears to be permissible to rearrange the ownership among the continuing shareholders to a significant extent without losing exemption for the equity.\(^{18}\)

Prior to 1934 there were three recognized methods of consummating an exempt merger, each of which required the necessary continuity: (1) a merger pursuant to state merger laws; (2) a transfer of at least a majority of stock of a corporation ("stock-for-stock" merger); and (3) a transfer of substantially all the assets of a corporation ("asset" merger).\(^{19}\) Stock-for-stock and asset mergers were exempted to provide uniform tax results for economically similar transactions even if state law did not allow statutory mergers.

The Revenue Act of 1934, however, provided that exemption was obtainable for stock-for-stock and asset mergers only if the consideration received was solely voting stock.\(^{20}\) If any cash, debt or non-voting stock was received by the sellers, the entire transaction was treated as a taxable sale to all shareholders. The enactment of a voting stock requirement is mystifying since the absence of a requirement that the per-

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The 1934 Code eliminated the complete exemption for securities if the principal amount of the securities received exceeded the principal amount of the securities surrendered; §§ 354(a)(2) and 356(d) contain the reference to the "principal amount," an error similar to the dependence of tax on "par value" in 1918; see note 1 supra.

17. The changes in the Revenue Act of 1924 which enabled boot to be taxed as a dividend (see note 16 supra) appeared immediately after the section which imposed a tax on the boot in both like kind and reorganization exchanges.


20. Revenue Act of 1934, § 112(g)(1)(A) and (B), 48 Stat. 705. In addition, the stock-for-stock mergers became exempt only if at least 80 per cent of the target corporation's stock was acquired (§ 112(g)(1)(B)). Since 1954 an asset acquisition is exempt if boot, including any liabilities to which the transferred property is subject, does not exceed 20 percent of the value of the property; § 368(a)(2)(B).
percentage of voting continuity be significant indicates a lack of concern for retention of voting power.

These new rules introduced an elective element into the tax law whenever the sale was for voting stock since it was fairly easy to add a small amount of cash, debt or non-voting stock to the voting stock without basically changing the economic nature of the transaction. This election was very important to the taxpayer since losses were not recognized in an exempt merger.\textsuperscript{21} It is clear that Congress was aware in 1934 of the possibility of recognizing losses since one of the major reasons for retaining the tax-exempt merger provisions at all was to prevent taking losses during the depression.\textsuperscript{22} Yet a statute was fashioned which did not prevent the taxpayer from electing to take a loss.\textsuperscript{23}

The 1934 rules contained another anomaly. If a statutory merger was available under state law, the option to shape the transaction as a taxable sale was available not only when the deal was primarily for voting stock, but also when a substantial amount of other consideration was used. Thus, if it was desirable to obtain tax-free equity, a statutory merger could be accomplished. If a tax loss was desired or if the capital gains tax on equity and non-equity was less than the tax at ordinary rates on the proceeds, taxed as a dividend, the taxable route might be followed. If an option as to the tax result was desirable to encourage mergers, however, it is difficult to understand why it should have been limited to transactions in which statutory mergers were available.

The Treasury tried to forestall these legislative developments by requesting general authority to deal with mergers by Regulation.\textsuperscript{24} However, Congress rejected the request and began the process of elaborating rules on exempt mergers which has not stopped today.\textsuperscript{25}

\textsuperscript{21} Revenue Act of 1934, § 112(e), 48 Stat. 705; the current provision is § 356(c).
\textsuperscript{22} A subcommittee of the House Ways and Means Committee had proposed eliminating the reorganization provisions; Prevention of Tax Avoidance, Preliminary Report of a SubComm. of the Comm. on Ways and Means, 73d Cong., 2d Sess. 8-9 (Comm. Print 1933). However, recognition of losses during the depression was seen as the immediate result of such a repeal (H.R. Rep. No. 704, 73d Cong., 2d Sess. 12-14 (1934), reprinted in, 1939-1 (Part 2) Cum. Bull. 563-64).
\textsuperscript{23} Under current law, though not in 1934, another major problem arises out of the elective quality of a transaction which is basically for voting stock but which will allow a small amount of other consideration to be added. Since the Revenue Act of 1936, the acquiring corporation's basis in the acquired property has depended upon whether the transaction is an exempt merger to the seller. If it is exempt the seller's basis carries over to the buyer, but if it is not exempt, the buyer's basis is cost. (Revenue Act of 1936, § 113(a)(7), 49 Stat. 1683). In many cases, the value of the assets has appreciated, and the acquirer is anxious to obtain the higher cost basis. In 1936 this problem might not have been perceived because of the depression.
\textsuperscript{24} See R. Paul, Reorganisations in Studies in Federal Taxation (3rd Series) 38 (1940).
\textsuperscript{25} The latest effort involves statutory mergers into subsidiaries. See Pub. L. No.
Continuation of the relaxed continuity of interest rules for statutory mergers is crucial to the consummation of conglomerate acquisitions. First, sellers often require something safer than common stock. The use of non-participating preferred stock is, therefore, desirable, and the buyer finds this congenial since the equity need not carry a voting privilege. Second, the acquisitions often occur in several stages, the earlier stages of which involve cash or debt. These earlier acquisitions give the buyer a chance to get information about the target to which only shareholders are entitled and contributes momentum to its later offers, which in turn encourages management and shareholders to put up less of a fight. Since a series of events are often judged as parts of one transaction for tax purposes the exemption of a later stage of an acquisition, which involves solely voting stock, can be assured only because the statutory merger route allows the use of non-equity.

Another episode in the development of tax exemption for mergers, which is significant for an understanding of the taxation of conglomerate mergers and the rule-making process, occurred in 1954 with the modification of the rules for so-called "creeping mergers." Prior to 1954, a seller was exempt when he sold stock solely for voting stock only if the corporation acquired eighty per cent of the target corporation in one transaction. A sale of thirty per cent of the stock in 1953 was not exempt if sixty per cent had been purchased in 1939. The 1954 Code provided that the second acquisition, which gave the acquiring corporation the required eighty per cent interest, would be exempt if the consideration in the second acquisition satisfied the strict solely-for-voting stock requirements. Exemption for these "creeping acquisitions," so named because the buyer can creep along in his acquisition rather than become the owner of eighty per cent all at once, might have resulted from impatience with granting an exemption to each shareholder only if all shareholders got voting stock. Once shareholders in the target corporation were not...

90-621, § 1(a) (1969), adding, § 368(a)(2) (D). The new rules refer to "substantially all" the assets being merged into the subsidiary and it is unclear whether this requirement was intended; 30 J. TAXATION 327 (May 1969).

26. See statistics in Part II(B) of the text.

27. When Lykes sought to acquire Youngstown Sheet and Tube, Lykes originally acquired less than majority control for debt. It later sought a statutory merger using convertible preferred and debt. In order to assure exemption, it limited the debt offer to an amount which, when combined with the earlier acquisition for debt, would not destroy exemption for the convertible preferred. Wall Street Journal, Jan. 20, 1969, at 34, col. 1.

In the LTV-Wilson merger, LTV bought 53 per cent of the stock for cash (Wall Street Journal, Jan. 9, 1967, at 4, col. 3) and then advised (with a certainty that defies explanation) that the acquisition five months later for equity of the remaining 47 per cent in a statutory merger was exempt. (2 P.H. CAP. ADJUSTMENTS 5595).


29. § 368(a)(1)(B).
required to continue meaningful voting control in the acquiring corporation, a requirement that all the former shareholders who constituted the controlling eighty per cent group must retain their management interest by receiving voting stock in the acquirer becomes hard to justify. Therefore, if some of them sold their stock at an earlier date for cash or non-voting stock, their lack of a continued voting interest would seem irrelevant to the other shareholders. As long as a particular shareholder received solely voting stock, and the acquirer obtained eighty per cent ownership, it would seem reasonable to grant exemption to that shareholder. 30

This rationale for exempting "creeping mergers" has not been rigorously pursued in the Code anymore than the continuity of interest requirements have been coherently developed. The exemption for a shareholder still depends upon all shareholders receiving solely voting stock in the transaction which provides the acquirer with eighty per cent ownership. Only the consideration received in an earlier unrelated transaction is disregarded. 31

The identification of transactions which are part of the plan for tax purposes is obviously difficult. There are indications that no rulings will be issued excluding a transaction from a plan if it occurs within six months of another sale and that the Internal Revenue Service views transactions within two years of each other as presumptively part of a plan. 32

In addition to limiting the exemption of creeping acquisitions in an irrational manner, the 1954 Code has explicitly granted this exemption only to stock-for-stock mergers, not to the statutory merger or the asset merger. The Service has ruled, however, that a statutory merger will be exempt despite earlier unrelated acquisitions, 33 and the Regulations appear to reach the same result if the acquirer already has eighty

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30. This "per shareholder" approach was referred to as "extreme" in ALI, Federal Income Estate and Gift Tax Project, Income Tax Problems of Corporations and Shareholders, 302 (Oct. 31, 1958) (Report of Working Views of ALI-ABA Study). A Subcommittee of the Advisory Group on Subchapter C to the House Ways and Means Committee suggested that as long as the individual shareholder received property with the required continuity, defined to allow some non-equity, he should be exempt if the acquirer had control of the target after the exchange. Report on Corporate Distributions and Adjustments from the Advisory Group on Subchapter C, 85th Cong., 1st Sess. 64 (Comm. Print 1957).
32. 27 J. Taxation 253 (Oct. 1967). The denial of a ruling when one transaction might destroy exemption for another transaction should not be confused with the provision in the Regulations which suggests that a sale for voting stock is entitled to exemption as part of a plan which later results in 80 per cent control within a 12-month period; Treas. Reg. § 1.368-2(c) (1955).
per cent of the target. However, an asset acquisition is apparently not exempt if the acquirer previously bought a significant amount of stock in an unrelated transaction.

The creeping acquisition rules are important in those conglomerate acquisitions which proceed by tender offer to shareholders, rather than by the statutory merger route. If earlier acquisitions for non-voting equity, debt or cash were deemed part of the plan of acquisition for tax purposes, the later acquisition for voting stock could not be exempt since only voting stock can be used in a stock-for-stock acquisition. Earlier sales for voting stock, however, might be exempt if followed at a later date by a further acquisition for voting stock which gives the acquirer eighty per cent control. Any promises, however, to the earlier sellers that they are or are not part of the plan are unreliable in the absence of a ruling from the Service.

The 1954 Code added one further provision which can be of significance in conglomerate acquisitions. Prior to 1954 taxpayers had developed a technique to obtain cash at capital gains rates without diluting their common equity position. Preferred stock would be distributed to common shareholders. This distribution was tax-free since stock dividends were taxed under the 1939 Code only if they were disproportionate. The preferred stock was normally a capital asset and its sale was taxed at capital gains rates. The 1954 Code sought to curb this abuse by tainting certain preferred stock so that the proceeds received on its sale would be taxed as ordinary income. It further provided that preferred stock received in tax-exempt mergers could also be tainted if

34. Treas. Reg. § 1.332-2(d) (1955). The thrust of the regulation is to exempt minority shareholders of the target since the acquiring corporation is already exempt (§ 332) and receives a carryover of the transferor’s basis under § 334(b)(1), a result which parallels the reorganization provisions. A critique of the irrationality of the acquiring corporation’s disappearing basis appears in Seplow, Acquisition of Assets of a Subsidiary; Liquidation or Reorganization, 73 Harv. L. Rev. 484 (1960).
36. Solitron had bought less than one per cent of Amphenol for cash. It later offered voting stock for the remaining interest, but a shareholder of the target obtained a ruling that the earlier cash acquisition was part of the plan which would render subsequent sales taxable; 28 J. Taxation 319 (May 1968).
37. Zapata Norress sought a ruling that a prior stock acquisition followed by a statutory merger was tax exempt on the theory that the prior equity was received as part of the plan to be consummated by the later statutory merger. Its purpose was to encourage the recipients of the tender offer to sell. 31 J. Taxation 319 (Nov. 1969).
40. § 306.
similar possibilities of abuse were present. In conglomerate acquisitions
the taint is often avoided because the stock is usually issued by public
corporations whose shareholders are thought to be less likely to receive
preferred stock to accomplish the bail-out of earnings described above
and because the preferred stock is usually a significant percentage of the
consideration received, a factor associated more with an investment
intent rather than an intent to sell.

The picture of the rule-making process that emerges from this history
is one of both judicial and legislative confusion. Mechanical judicial
interpretation failed to implement the original purpose of the statute,
and Congressional tinkering and legislative detail obscured that purpose
further. Once Congress created a patchwork of statutory rules, the courts
can probably be excused if their decisions appear to lack coherence. For
example, how is a court to decide whether a stock acquisition followed
by a liquidation should be analyzed as a stock or asset acquisition?
In this context, easy reliance on the "step transaction" approach is clearly
an "anodyne for the pain of reasoning." In one formulation, the step
transaction approach requires an intermediate step to be disregarded if
it serves no function in the light of the ultimate goal. When a liquida-
tion follows a stock acquisition, the stock acquisition is a meaningless
step to the acquirer who wants the assets, but it is crucial to the seller
whose votes for an asset acquisition were withheld thereby forcing resort
to the stock acquisition route. From whose point of view is one to
decide whether the intermediate step is meaningless? Another formulation
of the step transaction doctrine requires that the intermediate step

41. § 356(c)(1)(B).
42. In the ITT acquisition of Sheraton, where 14.86 per cent of the consideration
was preferred stock, the Service ruled that the preferred stock was § 306 stock but that
its disposition would not be tainted with ordinary income treatment. 2 P.H. CAP. ADJUST-
MENTS 5977.
43. When ITT acquired Rayonier, 55.46 per cent of the consideration was preferred
stock and the Service held that it did not constitute § 306 stock. 2 P.H. ADJUSTMENTS
5928.
44. PAUL, supra note 24, referred to a "confused Congress" passing the Revenue
Act of 1934.
45. The continuity rules are different. A stock acquisition admits of only voting
stock where an asset acquisition can be exempt despite a limited amount of boot (see note
20 supra) ; on the other hand, a creeping stock acquisition is exempt but a creeping asset
acquisition is not. See notes supra 29 and 35. See American Potash & Chemical Corp.
v. U.S., 399 F.2d 194 (Ct. Cl. 1968), petition for rehearing granted, 402 F.2d 1000 (Ct.
Cl. 1968) where the court has found it difficult to decide whether to analyze the trans-
action as a stock or an asset acquisition.
46. The phrase is Learned Hand's in Sansome v. Commissioner. 60 F.2d 931, 933
47. R. PAUL & P. ZIMET, Step Transactions, in Selected Studies in Federal Tax-
aton (2d Series) 200 (1939).
Rev. 485, 530-31 (1967).
be disregarded if it was part of a larger plan. But this formulation gives little guidance. For example, the issuance of fractional shares is recognized as a separate step in a merger despite an immediate redemption in accordance with the plan.\textsuperscript{49} A better, but unsettling, statement of the step transaction rule is that the intermediate step is recognized if there is a discernible policy in the tax law that it be recognized. Thus, fractional shares are given independent significance despite subsequent redemption since to disregard the step would interfere with a common and useful business technique. However, no guidance is given by the tax law in the case of a stock acquisition followed by a liquidation since there is no evidence whether the rules applicable to stock or asset acquisitions should prevail.

This discussion of the rule-making process leads to the preliminary conclusion that the courts and the Treasury are more suitable agencies for developing the tax law rationally than the legislature and that, had they done so, legislation in this area might not have developed into its current incoherent state.\textsuperscript{50}

Recent efforts to change the law concerning tax-exempt mergers have focused on Congress. On the one hand, it has been proposed that the present law be changed to require a significant continuity of interest amounting to twenty per cent of the acquirer's equity\textsuperscript{51} and, on the other hand, to abandon the continuity requirement still further for a per-shareholder approach.\textsuperscript{52} The exemption continues to thrive on the worn-out rhetoric of continuity. Little thought is given to whether the exemption provisions are now economically justified.\textsuperscript{53} Thus, when the House proposed requiring twenty per cent continuity in 1954, it exempted


\textsuperscript{50} For example, the problem of statutory mergers into subsidiaries (see note 25 supra) could have been handled by treating the transaction as a merger into the parent followed by a transfer to the subsidiary; see Rev. Rul. 64-73, 1964-1 Cum. Bull. 142, treating a conveyance to a sub-sub-subsidiary as a conveyance to a sub-subsidiary followed by a transfer to the remote subsidiary.

\textsuperscript{51} See ALI, 2 Federal Income Stat. §§ 601(a)(2) and 602(a)(2) (Feb. 1954 draft); the requisite continuity could have been provided by a 20 per cent voting interest without regard to the stock's participation in profits. \textit{Id.} at 310-11 and 311-13. The 1954 House Bill which developed into the Internal Revenue Code of 1954 contained a requirement that there be 20 per cent participation in the profits (H.R. Rep. No. 1337, 83d Cong., 2d Sess. 40), which the Senate deleted; S. Rep. No. 1622, 83d Cong., 2d Sess. 52, 53 (1954).

\textsuperscript{52} See note 30 supra.

\textsuperscript{53} Former Commissioner of Internal Revenue Sheldon S. Cohen has urged a review of the merger provisions on economic grounds in \textit{Conglomerate Mergers & Taxation}, 55 A.B.A.J. 40 (1969); see also Sandberg, \textit{The Income Tax Subsidy to "Reorganizations,"} 38 Colum. L. Rev. 98 (1938).
mergers of public companies. Apparently, the complexity of the Code has not only confused its interpreters but has channeled all efforts towards its more systematic application rather than a re-examination of the premises on which it is based.

B. DEBT AND ORIGINAL ISSUE DISCOUNT

It has already been noted that in a statutory merger a limited amount of debt can be received without destroying the exemption for equity, but that the debt might be taxed as a dividend. This section deals with installment sales and original issue discount rules which encourage the use of debt to purchase stock other than in a tax-exempt merger. The confusion and complexity in these areas is negligible compared with the law of exempt mergers. They will be discussed here primarily to provide a background for comparing the changes in the Tax Reform Act which rationalize the law of installment sales and original issue discount with the complex changes dealing with interest on debt issued by corporate acquirers.

If an individual makes a casual sale of personal property on credit for more than one thousand dollars, he can elect to postpone recognition of gain until he receives payment other than in the form of the debtor's promise or note. This rule had its origin in a Treasury Regulation allowing the taxpayer to report as income the portion of each installment received equal to the total gain on the transaction divided by the total contract price. Thus, if property with a cost of sixty dollars is sold for one hundred dollars in four equal installments, each twenty-five dollar installment results in recognition of one quarter of the forty dollar gain, i.e. ten dollars. The deferral of tax under these circumstances is related in rationale to the deferral which was once allowed if the proceeds had no readily realizable value. Both rules reflect a desire to avoid imposing a tax while the actual receipt of gain is too speculative. Unlike the merger provisions,

55. See note 16 supra.
56. § 453(b) (1) (B).
57. See note 2 supra. From 1921-24 the non-taxability of proceeds lacking a readily realizable marketable value might have provided a statutory base for exemption of the debt in many cases (see notes 7 and 8 supra).
58. § 453(a) and (b).
59. The example assumes that the interest paid is sufficient to avoid imputing a portion of the sales proceeds to interest under § 483.
60. The pervasiveness of the idea that the appropriate time to impose tax is the receipt of property having a readily realizable value is evidenced by its cropping up in unexpected places: (1) cash receipts are usually taxed to accrual basis taxpayers despite matching costs to be incurred in later years. Schlude v. Commissioner, 372 U.S. 128 (1963) (service business); but see Artnell Co. v. Commissioner, 400 F.2d 981, 984 (8th Cir. 1968) (if amount and time of future costs are certain, deferral might be allowed);
however, there is no doubt that the seller has realized gain or loss on the
transaction. The installment method is only a method of postponing the re-
cognition of income until a later date. Therefore, gain cannot be given
away in many cases where it could have been deflected to the donee if the
property had been received in a tax-exempt merger. For example, if the
debt on which no tax is paid is given to a relative during the donor's
life, the postponement of gain ceases;61 whereas if stock received in an
exempt merger were given away, the entire gain would be taxed to the
donee.62

Since the installment method is intended to relieve the taxpayer of
the burden of tax when receipt of the proceeds is doubtful, it is unavail-
able if a substantial percentage of the price is paid in the first year.63 The
rule not only identifies cases where there has been a collection of a
significant amount of the consideration but also those cases where the
initial payment is some evidence that subsequent payments will be made.64

The postponement of tax on corporate debt probably represents a
corruption of the original purpose of the installment sales rules, at least
if the debtor were solvent. The elimination of the deferral of gain when
certain corporate debt is received is one of the changes made by the Tax
Reform Act to be discussed below.65

From the buyer's point of view, a transaction is a taxable purchase
when debt is the sole consideration. The buyer, therefore, obtains a new
cost basis for the property purchased. The combination of a higher basis
for the buyer and deferral for the seller often makes the use of debt an

(2) A seller of real estate is taxed on the fair market value of the buyer's obligation
even if the seller reports income on the accrual method; Treas. Reg. § 1.453-6(a) (1)
(1958); (3) cash basis taxpayers must report gain in the year of sale when they receive
only a promise of an annuity from a corporation, trust, fund or foundation. Rev. Rul.
61. § 453(d).
62. Section 1015(a) can be cited for the donor's exclusion although it would prob-
ably be supported as a gloss on § 61. Election of the installment sales provision also
eliminates the stepped-up basis at death; §§ 691(a) (4) and 1014(a), (c).
63. An excess of 30 per cent is the current criterion; § 453(b) (2) (A).
64. The Revenue Act of 1928, § 44(b), 45 Stat. 805, raised the amount of down pay-
ment which could be received from 25 per cent to 40 per cent since the higher figure was
greater assurance of actual payment of the remainder; H.R. REP. No. 2, 70th Cong., 1st
Sess. 14-16, reprinted in, 1939-1 (Part 2) CUM. BULL. 393. A recent ruling requires that
there be at least two payments to qualify under § 453; Rev. Rul. 69-462 CUM. BULL. 7. The
case law background preceding this ruling is discussed in Appert, Installment Reporting
as a Substitute for a Tax-Free Reorganization, 22 TAX LAWYER 137, 139-47 (1968).
65. The House Report on the Tax Reform Act suggests that there was some doubt
about corporate debt being eligible for § 453(b) treatment under prior law, implying that
the statute might have been limited in much the same manner that the continuity of in-
terest rules were developed; H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 107
(1969). See also Bittker, Proposed Legislative Restrictions on Acquisitions of Stock by
attractive alternative to a tax-exempt merger during a period of rising prices.

The existence of original issue discount on the issuance of debt affects both the seller and the buyer and is a further factor to be considered in our examination of conglomerate acquisitions. A simple example of original issue discount is the issuance of debt with a hundred dollar face amount for ninety dollars cash. The ten dollar difference is in effect a deferred interest payment and is referred to as original issue discount. The buyer normally deducts such discount by accruing a deduction over the life of the debt. Until the Tax Reform Act, however, the seller did not report the accrued interest in the form of original issue discount until the sale or redemption of the debt unless the seller was a financial institution or similar investor who reported income on an accrual basis. There are several uncertainties in determining the existence of original issue discount. First, can there be original issue discount when property is sold for debt? Case law is conflicting, and the new law tries to resolve the issue in a manner discussed below.

Second, can there be original issue discount if the seller elects to be taxed under the installment method? One commentator has suggested that there can be no original issue discount in such cases because the full amount realized upon disposition of the debt is treated as proceeds of the sale of the property originally exchanged for the debt thereby leaving no amount which could be taxed as original issue discount. This

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67. See de Kosmian, Original Issue Discount, 22 Tax Lawyer 339, 345-47 (1969). The statutory pattern of § 1232 since 1954 and prior to the Tax Reform Act was to deny capital asset status for the debt but to treat the transaction as a sale or exchange if the debt was held more than 6 months. Presumably, the pre-1954 case law still applied to debt held 6 months or less. Thus, since United States v. Midland Ross Corp., 381 U.S. 54 (1965) treated the amount received for original issue discount under the 1939 Code as ordinary income which was not sales proceeds, the gain attributable to original issue discount on debt held for 6 months or less was not taxable as short-term capital gain since capital gains are realized only upon a sale or exchange; § 1222. Therefore, the ordinary income cannot be reduced by capital losses (§ 1211). This analysis is still applicable to debt held for six months or less after the Tax Reform Act.

68. Finding discount: Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962); American Smelting & Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942). Finding no discount: Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969); Paine v. Commissioner, 236 F.2d 398 (8th Cir. 1956); Montana Power Co. v. United States, 159 F. Supp. 593 (Ct. Cl. 1958), cert. denied, 358 U.S. 842 (1958). Whether there is original issue discount upon redemption of stock in the corporation issuing debt is a problem which the new statute, dealing with sale of property for debt, should not be interpreted to resolve (see note 136 infra).

69. See de Kosmian, supra note 67 at 352-54. He notes a Treasury argument (intended to persuade Congress to pass the imputed interest rules now found in § 483) which assumed that a sale under the installment method authorized by § 453 contained no interest element if property worth 1,000 dollars was sold for 1,300 dollars. But there is
reasoning leads to an anomalous result since it would allow the buyer to deduct the discount as interest while the seller reported the discount as sales proceeds. A better solution which the statute can certainly bear is to treat the amount realized on the disposition of the debt by the creditor as proceeds from the sale of the original property only to the extent that the face value of the debt is not attributable to original issue discount. Whenever there is imputed interest under section 483 the proceeds of the sale are adjusted downwards for purposes of the installment sales provisions to reflect that portion which is imputed interest. A similar adjustment should be made when the sale is to a corporation and there is original issue discount.

II. TAX REFORM ACT OF 1969 AND CONGLOMERATE ACQUISITIONS

A. LEGISLATIVE HISTORY

The Tax Reform Act of 1969 contains a number of provisions intended to modify some of the rules discussed above and, therefore, presents an opportunity for examining the legislative process in greater detail. President Johnson's tax reform proposals contained nothing which purported to deal with conglomerate acquisitions. In February, 1969, Chairman Mills of the House Ways and Means Committee introduced a bill which dealt with the deductibility of interest on debt related to certain acquisitions and with the eligibility of corporate debt for deferral under the installment method. The bill provided that if over thirty-five per cent of the consideration paid for stock was debt or property attributable to borrowing (e.g. cash borrowed from a bank), then a percentage of the interest was not deductible. It also eliminated the installment method when corporate debt was issued in registered form or with coupons attached.

When the Tax Reform Bill finally passed the House, it had acquired a third provision dealing with original issue discount. This provision

nothing in the Treasury statement to suggest that the buyer was a corporation which could have been covered by the original issue discount provisions.

71. The imputed interest provisions should not preclude a larger interest imputation under the original issue discount rules when a sale is made to a corporation. See de Kosmian, supra note 57, at 351-52; Treas. Reg. § 1.483-1(b) (3) (1966).
74. H.R. 13270, 91st Cong., 1st Sess., § 413, 229-37 (August 8, 1969) (hereinafter cited as House Version). The bill as passed appears in §§ 1232(a) (3), (b) (2) and 6049(a) (1) (C).
required lenders to accrue original issue discount periodically in all cases and required borrowers to report the interest attributable to original issue discount if the debt was in registered form. It also clarified the law by affirming that a sale of property for corporate debt can have original issue discount and by confirming recent regulations that there could be original issue discount when corporate debt and warrants were issued.

The provisions dealing with the deferral of corporate debt under the installment method and with original issue discount went through both the House and Senate without difficulty. They had both received support in the Nixon Tax Reform proposals. The only modifications made were to refine the bill to accomplish its purpose more accurately. First, corporate debt was ineligible for deferral not only if it was registered or had coupons attached, but also if it was readily tradable in an established securities market. Second, original issue discount could exist upon a sale of property only if either the property or the debt was traded on an established securities market thereby restricting original issue discount to cases where the valuation problems were not likely to be too formidable. In both cases the legislative process worked smoothly since the bill eliminated certain irrationalities in the development of areas of the law which were relatively uncluttered. It is important to remember, however, that the impetus did not come from a desire to rationalize the law but from hostility to conglomerate acquisitions which were thought to be encouraged by a seller's ability to defer tax on the proceeds of a sale and to evade tax on original issue discount. This observation should give pause to a judge or Treasury official who hesitates to play a role in developing the tax law because he believes that

78. The House version added to the Mills bill the category of "readily tradable" security (*House Version* at 228), and the Senate Finance Committee limited the loss of the installment method to situations where the registered debt was readily tradable; H.R. 13270, 91st Cong., 1st Sess. § 412, 284-85 (Nov. 21, 1969) (hereinafter cited as *Senate Finance Committee Version*). The Senate Finance Committee version also deleted (at 284-85) a rule imposed by the House version (at 227-28) that payments had to be periodic. The bill as passed appears in § 453(b)(3).
79. This provision emerged after floor debate in the Senate; H.R. 13270, 91st Cong., 1st Sess., § 413, 307-08 (Dec. 11, 1969) (hereinafter cited as *Senate Version*). The bill as passed appears in § 1232(b)(2).
Congress is ready and waiting to perform that task.

The legislative process behaved very differently in developing the new section dealing with the disallowance of an interest deduction on debt used in certain acquisitions. As the Mills bill passed through the House Ways and Means Committee its contours changed considerably with the addition of detailed elaboration and exceptions. The Nixon proposals had contained no similar section dealing with an interest deduction. The Treasury's view was that the problem was essentially that of distinguishing between debt and equity and was, therefore, best dealt with through Treasury Regulations. As in 1934, however, Congress turned down the invitation to refrain from acting.

The first change was to eliminate the requirement that thirty-five per cent of the consideration be debt. It was noted in the House Hearings that one offeror had simply replaced the debt with preferred stock to the extent necessary to avoid the new rules.

Second, a number of provisions were added which purported to focus the law on those conglomerate acquisitions in which the issuance of debt raised questions of the borrower's financial stability. The interest deduction would be disallowed only if the debt were issued to a seller since a bank could presumably determine financial viability. The debt/equity ratio or projected earnings/interest ratio of the borrower had to indicate a lack of cushion for the debt. An exception was introduced if the interest on acquisitions did not exceed five million dollars, which was intended to eliminate the application of the new law to the acquisition of small businesses by other small businesses or by employees to whom management wanted to sell; both these situations were presumably cases where the buyers could handle themselves without the protection of the tax law.

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81. See note 77 supra at 5054.
82. House Hearings at 2462 and 2485.
83. House Version at 220; House Hearings at 2451 and 2517; § 279(b) (1) ("issued to provide consideration").
84. House Version at 221; House Hearings at 2377-79 and 2463; § 279(b) (4). The final bill responded to a request made to the Senate Finance Committee (Hearings on the Subject of Tax Reform before Senate Finance Comm., 91st Cong., 1st Sess. 4164 (1969)) that cash flow be more closely approximated by adding depreciation to earnings and profits in determining projected earnings; see § 279(c) (3) (B) (ii). Strangely, this provision had not appeared in any of the versions of the bill prior to conference committee action.
85. The Senate Finance version (at 274-75) expanded the creditors to whom the debt could be subordinated from trade creditors to, in the alternative, a substantial amount of unsecured creditors; see § 279(b) (2).
86. House Version at 219; House Hearings at 2510 (small acquirer) and 2515-16 (employee buy-outs); § 279(a) (1). The 5 million dollar exemption is reduced by in-
Third, the interest had to be issued on debt which created public confusion about the value of the consideration. The above rules on financial stability were partly designed to protect the public from being misled. Another provision with this objective requires the debt to be issued with warrants or a conversion privilege before the interest deduction is disallowed.87

The House Ways and Means Committee asserted that it was refining the definition of debt and equity.88 One Congressman felt that if the public viewed convertible debt or a debt-warrants package as equity then that assessment was probably accurate.89 However, despite the claim that the new interest rules were intended to restore the law to its original purpose by refining a well recognized distinction, it is hard to view the new law as genuinely seeking to accomplish that purpose. When the Senate added a provision to the bill explicitly authorizing regulations to distinguish between debt and equity,90 it specified that the criteria developed by the House to deal with interest on debt used in acquisitions did not bind the Treasury in developing rules to make that distinction.91 Certainly, on the merits, it is difficult to see how the opportunity to exchange a fixed claim for a more uncertain claim which is more dependent on future profits can make the borrower's obligation less like interest while it is outstanding.92

The bill which finally emerged appeared, therefore, not merely as an attack on conglomerate acquisitions generally but as an attack on a sub-category of conglomerate acquisitions; viz., only those involving financially shaky buyers whose offers would confuse the public. However, there are some attributes of the new rules which seem not to fit this neat

87. House Version at 220-21; House Hearings at 2367-77, 2371-72, 2385, 2462; § 279(b) (3).
89. House Hearings at 2371-72 (ranking minority member Byrnes).
91. S. Rep. No. 91-552, 91st Cong., 1st Sess. 138-39 (1969). For example, non-resident aliens would still obtain the treaty benefits available to interest. Investors would have to accrue original issue discount (note 74 supra).
92. Congressman Byrnes (see note 89 supra at 2372) suggested that the convertible debt used in acquisitions was never intended to remain outstanding in view of the callability feature which would force the investor to exercise his option or give up the debt investment. However, this comment applies only if the debt is (1) callable and (2) either convertible or usable to acquire stock with the warrants. Furthermore, it only proves that the investor is likely to have a concern with future growth more analogous to a shareholder than a bondholder, not that the return on the investment is a dividend prior to the change in status.
explanation of its purpose, such as the 2/1 ratio of debt to equity which supposedly indicates financial instability. This suggests that another purpose may have been hidden in the statute’s complexity. In an effort to determine whether the statute was really directed at its declared objective, we made a statistical survey of the kinds of consideration used in conglomerate acquisitions to see what tax considerations, if any, were most likely to have an influence. The results of that study appear in the following section.

B. STATISTICS OF CONGLOMERATE ACQUISITIONS

A number of conglomerate acquirers were selected to see what their offers consisted of. Two lists of conglomerates were chosen from financial journals. Although this selection process resulted in omitting some conglomerate corporations from the study, the number of acquirers was thereby made manageable.

The Wall Street Journal and Prentice Hall Capital Adjustments Reporter were the two sources of data. These sources were searched for all transactions between January, 1968 and June, 1969 and, in addition, for those transactions going back to December, 1966 which involved the conglomerates appearing on the lists chosen and which were also on a list of tender offers presented to the House Ways and Means Committee.

Answers to the following questions were sought: (1) How often were tax exempt statutory mergers completed and did preferred stock figure prominently in such transactions? (2) When did the installment method and the interest deduction play a role in encouraging the use of debt in conglomerate acquisitions under circumstances where the new rules would eliminate the tax benefits? The data indicates that exempt statutory mergers using preferred stock were far more frequently used

93. When the Advisory Group proposed to define the ratio which would result in treating debt as equity, they suggested 5/1; SUMMARY OF THE SUBCHAPTER C ADVISORY GROUP RECOMMENDATIONS ON CORPORATE DISTRIBUTION AND ADJUSTMENTS, 86th Cong., 1st Sess. 3 (Comm. Print 1959). The ALI-ABA study suggested a minimum of 3½ to 1 (supra note 30 at 436).

94. Smith & Schreiner, A Portfolio Analysis of Conglomerate Diversification, 24 J. FINANCE 413, 423 (1969): A. J. Industries; Automatic Sprinkler; Bangor Punta; Bell Intercontinental; Eagle Picher Industries; Foremost-McKesson; Glen Alden; Gulf & Western; International Tel. & Tel. (hereinafter referred to as ITT); Ling-Temco-Vought (hereinafter referred to as LTV); Lehigh Valley Industries; Litton; North American Rockwell; Ogden; Studebaker-Worthington; Teledyne; Tenneco; Textron; Whittaker. The following additional conglomerates (not already listed in the previous source) are from FINANCE WORLD 12 (May 14, 1969): AMK; Avco; Avnet; City Investing; Colt Industries; Commonwealth United; Fuqua Industries; Indian Head; Kidde; Loew’s; National General; National Industries; Northwest Industries; Republic; U.S. Industries.

95. House Hearings at 2489.
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in conglomerate acquisitions than taxable debt; and that the tax benefits relating to the use of debt which have been eliminated by the new law were not a significant factor in conglomerate acquisitions.

Sixty-eight exempt statutory mergers were identified for which satisfactorily complete data was available. In thirty-seven of them, solely voting common stock was used to acquire the target's common stock. In another twenty-five acquisitions, some or all of the consideration was preferred stock. In five more acquisitions, a merger using preferred stock followed an earlier purchase of a minority interest for cash. Only one example was found where an exemption for a statutory merger was claimed after more than majority control was acquired for cash, presumably because of the likelihood that the earlier cash sale would be considered part of the later merger, thereby preventing the required

96. The transactions are listed in notes 97, 99, 100, 101 infra.

In many cases we identified a transaction as a statutory merger because shareholders of both corporations had to vote. In other cases, we assumed that the statutory merger route was followed since the newspaper used the term "merged" or "acquired" and there were no signs of resistance. When preferred stock was used as consideration, the plausibility of the above assumption is increased because exemption is only available for non-voting preferred in a statutory merger; although the newspaper did not specify whether preferred stock was voting or non-voting, we assume it was non-voting stock.

If the consideration was unspecified or the results of an offer or agreement were not reported, the transaction was omitted. Since many of these transactions were probably consummated as statutory mergers the data most likely understates the use of this acquisition technique.


98. If the newspaper referred only to "stock" of the acquirer, we assumed it was voting common stock.

99. Avnet—Carol Wire and Cable; Gulf & Western—Consolidated Cigar (taxable boot also received); Gulf & Western—Universal American Corporation; Gulf & Western—Bliss; ITT—Sheraton; ITT—Rayonier; ITT—Pennsylvania Glass; ITT—Continental Baking; ITT—Grinnell; ITT—Thorp Finance; ITT—Canteen; Litton—Landis Tool; Litton—UTD; National Industries—Colt; Teledyne—Landis Machine; Teledyne—Argonaut; Tenneco—Kern County; Textron—Fafnir Bearing; Textron—Polaris; Textron—Talon; U.S. Industries—Jane Colby; U.S. Industries—Stroole; U.S. Industries—Gloray Knitting Mills; U.S. Industries—Citizens Mortgage; Whittaker—Long Lok.

continuity of interest.\footnote{101}

Debt was used to acquire control in eleven cases.\footnote{102} The installment method of taxation was apparently available in five cases.\footnote{103} In two cases, convertibility made the use of the installment method doubtful in view of the Service's rumored position that convertibility creates an uncertainty in the value of the sales proceeds which makes the installment method unavailable.\footnote{104} In three cases, the percentage of non-debt exceeded thirty per cent thereby preventing the election of the installment method.\footnote{105} In one transaction, we could not determine the percentage of the down payment.\footnote{106}

The deduction for interest in circumstances where it would now be denied was apparently available in no more than four of the eleven cases. In eight of the eleven cases, the debt was issued with either a conversion privilege or warrants\footnote{107} thereby presenting the possibility that the new rules would disallow the deduction. The data presented to the House Ways and Means Committee on the debt/equity ratio of acquirers indicates, however, that only four of the eight transactions involved acquirers with inadequate equity cushions.\footnote{108} The information on sub-

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101. LTV-Wilson involved a 53 per cent cash acquisition followed by a statutory merger alleged to be exempt although the merger followed the cash acquisition by no more than 5 months.

102. Acquisitions for stock paid directly to selling shareholders were comparatively rare, perhaps because of the unlikelihood of exemption. The following are illustrative: City Investing—General Development Corp. (at least 49 per cent acquired); City Investing—Home Insurance (acquired over 80 per cent; counsel advised that exchange exempt, from which it can be inferred that the preferred stock offered was voting preferred); Gulf & Western—Security Insurance (unsuccessful offer of preferred contingent on receipt of 80 per cent of target; the 80 per cent goal might not indicate the desire for an exempt acquisition since there is no suggestion that the preferred was voting stock; another tax reason for seeking 80 per cent is the availability of tax free dividends from the target-subsidiary (§ 243(a) (2) and Treas. Reg. § 1.1502-14(a) (1) (1966)); Northwest—Chicago, Milwaukee R.R. (88 per cent acquired; probably an exempt stock-for-stock merger); Avco-Embassey (target became a subsidiary; might have been an exempt stock-for-stock merger if the preferred offered was voting stock; the target was owned primarily by one family firm).

103. The transactions are listed in notes 103-06 infra.

104. See note 158 infra. Gulf & Western—Associates Investment Co. (counsel's opinion nonetheless suggested installment method available); Avco-Seabord (same).

105. Fuqua—Interstate Motor; AMK—United Fruit; National General—Great American Holdings.


107. These were the transactions listed in notes 103 (except Tenneco—Newport News and Glen Alden—Schenley) and in 104 and 105 supra.

108. Gulf & Western (2 transactions), Avco and LTV. The data on equity
ordination of the debt is incomplete, but it appears that the debt was usually subordinated. Data on the earnings/interest ratio was not before the Committee and the question was not pursued.

Debt was used in three other transactions which cannot clearly be described as successful or unsuccessful. In one case, the offeror got thirty-three per cent before selling out. In another, the acquisition was tied up in antitrust litigation before it finally collapsed. In a third case, the offer which included both debt and equity seems to have prevailed over an equity—cash offer after a long battle. In all three cases the installment method would not have been available since consideration other than debt exceeded thirty per cent. An equity option was offered in all three cases; the debt/equity ratio of the offeror exceeded the 2/1 limit in two of them.

Debt was offered in six unsuccessful attempts to acquire a company and in five of them an exempt merger prevailed.

Since the lists of conglomerate acquirers which were used in this study might be considered incomplete, four other tender offer transactions which were presented to the House Ways and Means Committee were examined to see if the new interest deduction rules would have had an effect on successful acquisitions. The data indicates that the new rules would have had almost no effect. Kinney did not offer any debt in acquiring Warner Brothers. General Host offered debt to the owner of Armour but the debt/equity ratio was not over 2/1. Lykes used cushions does not indicate whether it is based on adjusted basis, fair market value or book value of the assets; House Hearings at 2378.

109. Five of the 11 successful acquisitions involving debt were described in a list presented to the House Ways and Means Committee (House Hearings at 2378) and all of them involved subordinated debt. Gulf & Western—Brown; Avco—Seabord; LTV—Greatamerica; AMK—United Fruit; Glen Alden—Schenley.

109a. Gulf & Western—Allis Chalmers.


111. Bangor Punta—Piper Aircraft.

112. Gulf & Western; Bangor Punta (House Hearings at 2378).

113. Gulf & Western lost to Atlantic Richfield (exempt statutory merger using preferred) to acquire Sinclair; Loew’s lost to Control Data (exempt statutory merger using only common) to acquire Commercial Credit; Automatic Sprinkler lost to Jim Walter (exempt statutory merger using preferred) to acquire U.S. Pipe; Bangor Punta lost to American Machine and Foundry (exempt statutory merger using only common) to acquire Harley-Davidson (Bangor Punta also made an exempt offer but it was too late); Northwest Industries lost to City Investing to acquire Home Insurance (counsel for City Investing advised that offer was tax exempt; apparently offer was for a stock-for-stock merger). AMK lost to National General to acquire Great American Holdings; both offered debt.

114. House Hearings at 2378.

115. Id. Although it acquired 57 per cent of the target, the acquirer sold out, perhaps because without 80 per cent ownership the dividends needed to pay the interest on the debt would have been taxable (see note 101 supra).
debt to buy a minority interest in Youngstown Sheet and Tube before entering into an exempt statutory merger; equity options were used with debt to acquire 23.5 per cent of the target, but debt alone was used to acquire up to forty-nine per cent control. Crane offered convertible debt but lost in its efforts to obtain Westinghouse Air Brake to American Standard's offer of convertible preferred in a tax exempt statutory merger.

C. Hidden Special Legislation

The data indicates that the tax benefits associated with debt which the new law eliminates were not significant in encouraging conglomerate acquisitions. The most logical candidate for change in the tax law directed towards conglomerate acquisitions would have been the exemption for preferred stock in statutory mergers. This suggests that antitrust problems were not central to the House Ways and Means Committee's concern. Indeed, there are a number of exceptions in the new law which give encouragement to conglomerate acquisitions, such as the exception for interest on debt to acquire eighty per cent ownership if fifty per cent was owned on October 9, 1969 and the permission to compute the earning/interest ratio on a consolidated basis if eighty per cent of the target were later acquired.

There is nothing surprising in the conclusion that conglomerate acquisitions were not the focal point of concern in bringing about the changes in the rules concerning installment method and original issue discount, which did no more than rationalize the law. However, the disallowance of the interest deduction purported to derive primary impetus from economic policy despite suggestions that one purpose was to apply standards distinguishing between debt and equity.

Anyone contending that conglomerate acquisitions were a major concern would be compelled to concede that the data showed exempt statutory mergers to be a far more significant factor in encouraging successful conglomerate acquisitions than debt, but would assert that there were really two overriding concerns; viz., conglomerate acquisitions and acquisitions in which the public was misled by financially shaky debtors. Indeed, the first witness before the House Ways and Means Committee was the Chairman of the Securities and Exchange Commission, not the spokesman for the Antitrust Division of the Department of Justice. However, the data on public confusion presented to the Com-

116. § 279(i)(2), added by, Tax Reform Act, § 411(a). This was designed to help LTV acquire Jones & Loughlin, (House Hearings at 2519) a remarkable feature for a bill aimed at conglomerate acquisitions.
117. § 279(d)(3), added by, Tax Reform Act, § 411(a).
118. House Hearings at 2363.
Committee was so unrelated to the data on successful conglomerate acquisitions and the information on financial stability so unrelated to the strictures of the new law that it seems more likely that this data was used to encourage acquiescence in a bill with a different design.

First, there were eighty-three tender offers on a list designed to indicate the prevalent role of debt in offers to the public. Only ten involved debt offers by conglomerates who are on the lists used in this study and, of these, only three were successful.9

Second, another list of twenty-five offers, which was meant to show the widespread existence of an inadequate cushion for the debt, included only ten transactions with the proscribed ratio of debt to equity. Of these ten, only three were offers of debt to the seller directly thereby coming within the scope of the new rules.20

The ambiguities of the data presented to the Committee as proof that financial instability and a misled public were a problem in conglomerate acquisitions are easily resolved if a different purpose is ascribed to the law. President McCullough of Collins & Aikman made an appearance before the House Ways and Means Committee to plead for his company’s freedom.2 His testimony established that his company was an old and established business of some 125 years which was being pursued by Chelsea, a smaller nouveau riche company (founded 1964) which was

119. *House Hearings* at 2489-90. The successful ones were AMK—United Fruit; Glen Alden—Schenley; and National General—Great American Holdings. The transactions which were not successful were AMK—Great American Holdings; Automatic Sprinkler—U.S. Pike & Foundry; Gulf & Western—Allis Chalmers; Gulf & Western—Sinclair; Loew’s—Commercial Credit; Northwest Industries—Home Insurance; Northwest Industries—B. F. Goodrich.

120. *House Hearings* at 2378. Automatic Sprinkler—Logan (cash); Avco—Seaboard (conv. debt, debt and warrants); Bangor Punta—Waukesha Motors (conv. pfd. and common); Commonwealth United—Sunasco (pfd.); Gulf & Western—Brown (debt and warrants); Leasco Data Process Equipment Co.—Reliance Insurance Co. (conv. pfd. and warrants); LTV—Greatamerica (debt and warrants); National Industries—Crescent (conv. pfd. and common); Tailey—General Time (not in data); Riker Video—Standard Kollisman (conv. pfd. and warrants).

121. *House Hearings* at 2460-75. Apparently Northwest’s attempt to acquire Goodrich also provided some impetus for the bill (*Senate Hearings* at 4159). The Northwest spokesman pointed out that the interest deduction rules in the Mills bill were directed solely at stock acquisitions, not asset acquisitions, thereby discriminating against offers which lacked the consent of management. The House version ultimately applied to asset acquisitions as well (at 220) and the final bill contains such a provision (§ 279(b) (1) (B)). However, the role of debt in asset acquisitions is so negligible that the final version of the bill which disallows interest deductions in such acquisitions does not overcome the inference derived from the original version, *i.e.*, that it was intended to protect management. Of the transactions listed in notes 103-06 only Fuqua—Interstate Motors, Loew’s—Lorillard and Tenneco—Newport News were asset acquisitions for debt. In only one case might the new law have applied; Tenneco did not offer equity options; Loew’s debt/equity ratio was less than 2/1; Fuqua offered warrants; we have no information about its debt/equity ratio.
one-third the target's size. It was Chelsea which had reduced its debt to
less than thirty-five per cent of the consideration to avoid the requirements
in the original bill.\textsuperscript{122} The offeror was willing to give a package of debt,
preferred and warrants and its debt/equity ratio was coincidentally
2.08/1.00.\textsuperscript{123} If the new law is viewed, therefore, as an attempt to
protect established businesses from takeovers by new companies, then the
pieces of the puzzle fit neatly into place. It is not strange to disregard the
use of statutory mergers, to rely on data which inadequately demonstrates
the role of debt in successful conglomerate acquisitions, to encourage
conglomerate acquirers to obtain eighty per cent of the target or to define
an inadequate equity cushion very strictly if the new law is an excise tax
on takeovers of established companies.\textsuperscript{124}

This invites the question whether the legislative process openly
addressed itself to the economic issues involved in imposing such an
excise tax and to the wisdom of using the income tax to meet whatever
problem was perceived.\textsuperscript{125} The above analysis suggests that it did not.
The data was a smokescreen which created an impression that the
interest deduction provisions had an objective different from their actual
purpose. Congress simply neglected testimony that the economic effects
of the tax benefits withdrawn were highly problematical.\textsuperscript{126} It is impossible
not to ascribe this style of legislative behavior, at least in part, to the ease
with which the new rules blend innocuously into the statutory labyrinth.
The operation of legislation in serving a narrow spectrum of interests
remains easily hidden except to a few when it is placed in a setting as
complex as the current statute.

D. Excessive Detail

The analysis of the legislative process in developing rules for
corporate acquisitions has frequently returned to the problem of exces-
sive statutory detail and the risks it presents of confusing the interpreters

\textsuperscript{122} House Hearings at 2462.
\textsuperscript{123} House Hearings at 2463.
\textsuperscript{124} There is certainly an irony in the sudden punitive use of the tax law for anti-
trust purposes which further suggests an ulterior motive. \textit{See e.g.}, the provisions to re-
lieve the tax burden when DuPont divested itself of General Motors stock; §§ 301(f),
312(k), 535(f), 543(a) & (d), 545 & 1111. The Tax Reform Act has exempted distri-
buting corporations from tax on appreciated property when the distribution is in a re-
demption pursuant to an antitrust decree; § 311(d) (2) (D), \textit{added by}, \textit{TAX REFORM ACT},
§ 905(a).
\textsuperscript{125} \textit{See Sax, The Conglomerate & Tax Reform: A Brief Review}, \textit{25 TAX L. REV.}
\textsuperscript{126} House Hearings at 2373 (SEC Chairman did not know if interest deduction
encourages acquisition); at 2394 (antitrust official will not comment on effect of tax
law); at 2490 (representative of T.T. Grimm who supplied the list of tender-offers ac-
knowledged the lack of study of the effects of the tax law).
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of the law and hiding the narrow purposes of proposed legislation. This section considers this problem more fully.127

Detailed provisions are normally enlisted to accomplish one or more of three goals. First, they are used to eliminate unintended benefits, i.e. loopholes. The collapsible corporation provisions128 and the rules concerning preferred stock129 have this purpose.

Second, the rules may be designed to influence behavior either favorably, as a subsidy, or unfavorably, as an excuse. For example, section 303 guarantees capital gains treatment so that the tax cost of certain redemptions after death will not be prohibitive,130 and "Subpart F" seeks to discourage foreign investment.131 The use of detail when the tax law seeks to effect behavior is, to some extent, impelled by the institutional limitations of using the tax law in this manner. Generality in statutory language would seem appropriate only if the administering agency is capable of making expert judgments in specifically applying the general provisions. Since the Treasury rarely has that capability, the alternative usually relied upon is statutory detail which precludes Treasury discretion but offers some hope of accomplishing the desired objective.132

127. We are not concerned with the complexity of record keeping and completing forms which can be the product of many undetailed rules. The Tax Reform Act has responded to this problem in a number of ways; § 141(a), (b) and (c) (increased standard deduction and low income allowances), amended by, TAX REFORM ACT, § 802 (a); § 6012 (filing requirements equal level of exempt income) and § 6014(b) (computation of tax by Service), amended by, TAX REFORM ACT, §§ 941(a) and 942.

128. Section 341 tries to prevent personal service income and gain on the sale of inventory from being taxed at capital gains rates.

129. Section 306 tries to prevent a bail-out of earnings at capital gains rates.

130. § 303.

131. §§ 951-64.

132. The alternative of delegating the decision on tax deductibility to another agency is beginning to find favor. The deductibility of expenses violating public policy has occasionally been delegated to a certifying executive agency; see, e.g., I.T. 4105, 1952-2 CUM. BULL. 83, and Weather-Seal Mfg. Co. v. Commissioners, 16 T.C. 312 (1951). The Tax Reform Bill appears to be moving toward this approach. It provides for the loss of a deduction for bribes, kickbacks and two-thirds of the damages in antitrust cases where there was a conviction or a plea of guilty or nolo contendere in connection with the activity. § 162(c) & (g), as amended by, TAX REFORM ACT, § 902(a) & (b). It is unclear, however, whether these provisions are exclusive or merely guarantee loss of a deduction in the situation described.

The Tax Reform Act has also delegated authority to grant "tax subsidies" in several cases: § 169(d) (certified pollution control facility) added by, TAX REFORM ACT, § 704(a); § 514(c) (6) (acquisition indebtedness insured by Federal Housing Administration), added by, TAX REFORM ACT, § 121(d); §§ 1039 and 1250(a)(1)(c)(ii) (rollover exemption and limited recapture on sale of housing projects insured under certain provisions of National Housing Act), added by, TAX REFORM ACT, § 910; § 187 (certified coal mine safety equipment), added by, TAX REFORM ACT, § 707. But see § 167(k)(3), added by, TAX REFORM ACT, § 521(a) where HUD policies are apparently to be administered by the Treasury.

See also a proposal to use the tax law to encourage foreign investment which contemplated that AID, not the Treasury, would determine eligible projects. Hellawell,
Of course, the loophole-closing function and the subsidy-excise function are often mixed. The new rules on industrial revenue bonds were motivated both by an attempt to eliminate an unintended tax benefit and to preserve incentives for certain activities.\textsuperscript{133}

Third, detail may also result from a simple desire for certainty. In part, this objective is related to the subsidy function since fuzzy areas may tend to inhibit desirable activity. However, the quest for certainty also has the broader goal of easing the task of compliance for taxpayer and tax counselor. In this regard, the objective of certainty is potentially inconsistent with the goal of closing loopholes since the presence of grey areas can discourage the brinkmanship which leads to unintended benefits.

Despite their alleged advantages, detailed provisions present a number of serious problems which counsel against their use. First, the possibility that they will obscure special legislation has already been noted. Second, certainty is rarely obtained. For example, the following questions have been left unresolved by detailed provisions: (1) Will the existence of more than fifty per cent continuity of interest in an acquiring corporation result in dividend treatment to some shareholders of the acquired company?\textsuperscript{134} (2) When is debt subordinated to the "payment of any substantial amount" of unsecured debt?\textsuperscript{135} (3) Do the new rules on original issue discount require finding such discount if the issuing corporation redeems its own stock which is traded on an exchange?\textsuperscript{136} Furthermore, even if the detail avoids the ambiguities it pretends to eliminate, it surely fails to accomplish the objective of enabling a general practitioner to counsel clients on tax problems. Ironically, Congress has recognized its inability to achieve certainty in the most detailed of statutory provisions.

\begin{verbatim}
133. § 103(c).
134. Compare Reef Corp. v. Commissioner, 368 F.2d 125, 137 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967) (less than 50 per cent new persons sufficient continuity for reorganization) with Gallagher v. Commissioner 39 T.C. 144 (1962) and Lemmet v. Commissioner, 54 T.C. No. 41 (1970). It is possible that the old much-maligned case of Weiss v. Stearn, 265 U.S. 242 (1924) will be revived. It is the only one of the cases pre-dating the statutory exemption for mergers which did not tax the sellers on the equity received; it is also the only case in which the only change, other than the formation of a new corporation in the same state, was 50 per cent of the equity ownership. Cf. Casco Products Corp. v. Commissioner, 49 T.C. 32 (1967) (new corporation treated the same as the old corporation despite nine per cent redemption without regard to reorganization provisions; therefore, net operating loss carryback allowed).
135. § 279(b) (2) (B), added by, Tax Reform Act, § 411(a).
136. See Erie Lackawanna R.R. Co. v. United States, 70-1 U.S.T.C. ¶ 9245 at 82,780 (Ct. Cl. Feb. 20, 1970). The case held, in effect, that if stock was previously issued for 100 dollars, a redemption for 100 dollars of debt when the stock is worth 90 dollars does not result in original issue discount.
\end{verbatim}
by simply giving up and explicitly delegating large portions of rule-making power to the Treasury.\(^{137}\)

Third, confusion bred by the detail leads everyone astray. Congress makes irrational mistakes, such as the failure to apply the collapsible corporation rules to short-term capital gains\(^ {138} \) and the application of section 303 to stock not available to pay death taxes.\(^ {139} \) Furthermore, the detail feeds upon itself by encouraging more detail to resolve the errors of earlier statutes.\(^ {140} \)

Courts lack guidance thereby depriving the law of an important source of internal growth.\(^ {141} \) When general language backs up detailed provisions intended to close a loophole, it is difficult to discern the purpose of the statute in the light of which the general provisions are to be judicially interpreted. What, for example, is a "device" under section 355?\(^ {142} \) Perhaps because of the statute's complexity, the term has sometimes been endowed with a life of its own apart from the statute's underlying purpose.\(^ {143} \) The lack of apparent statutory purpose also encourages courts to adopt literal approaches to statutory interpretation. Thus, the capital gains provisions of section 351 have prevailed over rules in section 304 designed to identify dividends.\(^ {144} \) As a result capital gains

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137. Numerous provisions dealing with income on foreign investments require Treasury elaboration on substantive not procedural issues; see, e.g., §§ 954(d)(2), 955(b)(3), 960(a)(1), 961(b), 962(a), 963(a), 963(e)(1), 963(c)(4)(C), 963(f), 964(a), 970(a)(1), 1246(a)(2), 1246(c), 1248(a), 1248(c), 1248(e).

138. Section 341(a) is inapplicable if the gain is short-term even though a capital loss will offset such gain but would not offset the personal service income or the gain on inventory which § 341 is intended to reach (§ 1211(b)).

139. Section 303(a) applies if the redeemed stock is included in the taxable estate even though a relative of the decedent might own the stock and the stock would not have been available to pay the taxes.


141. The classic statement of befuddlement is Learned Hand's grievance that the income tax provisions "dance before my eyes in a meaningless procession: cross-reference upon cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." Hand, Thomas Walter Swan, 57 YALE L.J. 167, 169 (1947).

142. § 355(a)(1)(B).

143. In Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), on remand, 22 T.C.M. 911 (1963), the taxpayer successfully persuaded the court not to tax a spin-off by urging the relevance of his purpose to provide a separate asset in a separate corporation for a charity. No attention was given to whether the purpose had probative value in indicating the likelihood of a continuation of the investment, which is a major reason for § 355 and which the "device" rule, if it is to be relevant at all, should implement.

144. Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968). See also, Kelly v. Commissioner, 293 F.2d 904, 911-12 (5th Cir. 1961) in which the court placed considerable reliance on the Code's use of the indefinite article "a" in reaching a decision which
rates were applied because the investors had eighty per cent continuity of interest, rather than a fifty per cent to seventy-nine per cent continuity of interest in the acquiring corporation.

An oversimplified response would attribute the problem to bad draftsmanship. The easy rejoinder is that there is considerable evidence that such draftsmanship is inherent in the process of tax legislation. So many drafters try their hand at the final product that a first draft syndrome may be encouraged in which no one feels responsible for the final result. And, of course, there is always the tendency to downgrade the drafting process. Furthermore, there is a legislative rush about tax law which discourages craftsmanship.

More significantly, the quest for certainty disregards the elusiveness of the goal in the context of a complex economy and an inventive tax bar. Congress seems to recognize this elusiveness when it creates general provisions to give the taxpayer escape hatches from detailed restrictions, and to give the government a final opportunity to impose a tax, even if the taxpayer successfully negotiates the labyrinth.

Unfortunately the habit of detail has become engrained in the lawmaking process. There seems to be complete disregard of the doubtful attainability of certainty and the effect of detail in obscuring purpose. This lament is not a new one. Sometimes it is followed by disclaiming a desire for "Hellenic simplicity." However, while Hellenic simplicity in the tax law is not attainable, statutory simplification is not an ephemeral goal. The desirability of a shift away from statutory elaboration made avoidance of the collapsible corporation provisions easier than it otherwise would be; and Newman Co. v. United States, 70-1 U.S. TAX CAS. 9262 at 83,025 (2d Cir. 1970), in which the court refused to tax a nonresident corporation on the fair market value of a dividend under § 881 and instead taxed only the adjusted basis pursuant to § 301(b) (1) (B). Compare the contrary approach in Goldstein v. United States, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967) which held that "interest" in § 163 did not include interest incurred in a venture with practically no hope of economic profit other than the gain resulting from the tax law; and Commissioner v. Wodehouse, 337 U.S. 369, 391-92 (1949), in which royalty income was given an expansive definition when received by nonresident aliens.

145. See Woodworth, Procedures Followed by Congress in Enacting Tax Legislation and the Role of the Joint Committee Staff in that Process, 18 S. CAL. TAX INST. 21 (1966).
146. See Cary note 140, supra at 270. Very little seems to have changed. Public hearings on the Tax Reform Act were held during the first half of 1969, but no bill was examined by the House Ways and Means Committee until July 28; H.R. 91-413 (Part I), 91st Cong., 1st Sess. 214 (separate views of congressman Gibbons). The bill was published August 2 (Senate Hearings, at 4156). It passed the House on August 8.
147. See, e.g., § 306(b) (4).
148. See, e.g., § 355(a) (1) (B).
150. Cary, supra note 140 at 260.
RULE-MAKING PROCESS

to the greater use of Treasury regulations in the rule-making process will be explored in part IV. First, however, some developments of the tax law affecting conglomerate acquisitions, which primarily involve administrative rule-making, will be examined.

III. SWEETENERS

Two types of sweeteners are often used in conglomerate acquisitions, both of which hold out the promise of a greater amount of common equity than is received in the initial transaction. The option to obtain more common equity, which may take the form of either a conversion privilege or separately salable warrants, will be considered first. The discussion deals with the effect of an option on tax-exempt mergers, tax-deferred sales, the existence of original issue discount and with taxability when the option is exercised. A second type of sweetener to which we then turn is the contingent right to increased future equity, other than at the seller’s option, such as the contingent right to more stock if the target’s profits develop favorably. The effect of such contingent equity on tax exempt mergers will be discussed.

In several instances, current law in this area is in a state of pre-statutory development analogous to the law of exempt mergers prior to 1934. The analysis, therefore, provides an opportunity to study how the courts and the administration could develop the law rationally without legislative intervention.

A. OPTIONS

1. Convertibility

   a. Effect on Tax-exempt Merger

In a close case the convertibility of debt or preferred stock may increase the possibility of satisfying continuity requirements since it creates a dependence on future income which might not be carried by the security to which it is attached. The investment, however, is not treated as the equivalent of the stock into which it can be converted. On the other hand the conversion feature is not treated as separate consideration, and convertible voting preferred will qualify as voting stock.

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151. In some cases the option may be to acquire a predetermined increasing amount of common equity; see, e.g., Litton-Landis, 1 P-H Cap. Adjustments 1988-89.


154. But see Rev. Rul. 70-108, I.R.B. 1970-10, 12 in which a nontransferrable right,
b. Effect on Installment Method

The first question is whether the value of the conversion privilege is a down payment in the year of sale. Selling-taxpayers will often argue that it is a down payment since it would provide the needed second payment if the sale is to be eligible for the installment method. It is generally believed, however, that the conversion privilege will not be treated as a separate payment although the Treasury has yet to rule on the subject. If the conversion privilege is not a separate payment, there would be no tax on its value if the convertible debt is eligible for the installment method because other property satisfies the second payment requirement.

The issue can only be resolved by considering the kind of transactions meant to be covered by the installment sales provisions. The rationale for disregarding the conversion privilege would be that the installment sale provisions should disregard property not transferable separately from the debt which was assumed to be lacking readily ascertainable value. If this approach were rigidly applied, however, debt would be eligible for tax deferral under the installment method even if a major element of value were the conversion feature. Perhaps the best way to resolve the issue is to disregard the conversion feature if it is not a substantial part of the total package. It would be strange to lose deferral when the certainty of realizing gain decreases because part of the sales price depends upon the future success of the business to a greater extent than does the debt obligation. It is true that this irrationality is inherent in the installment sales provisions which were not intended to allow deferral of tax on equity. Still, where the equity interest is not substantial and the Code can bear the interpretation, it would be appropriate to disregard the conversion privilege.

A second problem arises from an unpublished position of the Service attached to voting convertible preferred, to buy additional common stock for cash at the time of conversion was held to be property other than voting stock.

Another issue arising out of the convertibility of preferred stock is the relevance of convertibility for the stock's status as § 306 stock. Section 305(h)(5) (as amended by the Tax Reform Act § 421) authorizes the taxation of convertible preferred as a dividend if it is likely to be used to give some shareholders cash while other shareholders enjoy an increase in their share of future profits. Although the new provision is not made expressly applicable to the definition of § 306 stock received as a dividend or in a merger, it is possible that it will influence that definition. See generally Metzger, The Impact of Section 306 Upon Convertible Preferred Stock Issued in a Corporate Reorganization, 116 U. PA. L. Rev. 755 (1968).

155. The importance of this question is diminished by the rules preventing the use of the installment method when certain corporate debt is received. See note 78 supra.
156. See note 64 supra.
157. See Appert, supra note 64 at 149.
that, because the element of convertibility introduces uncertainty into the value of the consideration received, the installment method cannot be elected. This view apparently finds its origin in the statutory requirement that a percentage of total gain realized on the sale must be taxed when each installment is received, and this percentage cannot be figured if the sales price is uncertain. But property can be received in an installment sale which is difficult to value. The real issue is whether the receipt of such property in an installment sale should be treated differently because the conversion privilege is not itself taxed at the time of sale. It seems that the decision not to tax the conversion privilege at the time of the sale rests on the analysis of the intent of section 453 outlined above, and there is nothing in that analysis which suggests violating the normal rule that a downpayment of property which is difficult to value does not, of itself, destroy eligibility for the installment method.

c. Original Issue Discount

Several questions arise concerning the effect of a conversion privilege on the existence of original issue discount. Even if the new law prevents the borrower from deducting original issue discount as interest, it is important to determine its existence since it will be taxable at ordinary rates to the investor and can be the subject of a reporting requirement for the borrower. The stipulation in the new law that there can be original issue discount only if either the stock sold or the convertible debt received is regularly traded on an established securities market is unlikely to present a problem in conglomerate acquisitions since one of the parties to the transaction is likely to meet the requirement.

The first problem is whether the value of the convertibility element can result in original issue discount. For example, if a one hundred dollar face amount convertible bond were issued for one hundred dollars of stock and the conversion feature were worth ten dollars, does the investor receive ten dollars in original issue discount upon the bond's redemption?

158. 30 J. TAXATION 198 (March 1969) (noting that counsel nonetheless advised that tax deferral was available). See also Massing, Contingent Payments in Taxable Acquisitions, 1969 S. CAL. TAX INST. 229, 249-50.

159. § 453(a), (b). The general problem of uncertainty of consideration was at one time dealt with by allowing the transaction to qualify if the minimum and maximum amounts were specified, but the Service will no longer rule in such cases; 30 J. TAXATION 288 (May 1969).

160. The tax effect of converting the debt is discussed below; see text accompanying notes 169-79.

161. Since United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) holds that the discount serves the "same function as stated interest", the rules on corporate acquisition indebtedness would apply to the borrower.

162. See note 74 supra.
The Treasury has not treated the conversion element as giving rise to original issue discount, a conclusion supportable on the theory that payment by the corporation on redemption of the debt is, to the extent it is attributable to the conversion privilege, a payment to repurchase the option, not interest.

However, even if the value of the conversion feature itself is not original issue discount, difficult problems still arise in deciding whether there is original issue discount in certain situations. If the convertible debt is traded on an exchange, its value will be determinable and the original issue discount can be easily identified. However, if only the stock is traded on an exchange, it is not clear whether discount exists since, in conglomerate acquisitions, premiums are often paid for stock above listed market value. For example, if stock is traded on an exchange for ninety dollars and the face value of the convertible debt is one hundred dollars, is the extra ten dollars original issue discount or a premium paid for the stock? To decide, one cannot avoid valuing the debt element by estimating its worth without the conversion feature to see whether its value plus that of the conversion element is less than one hundred dollars unless the new law is interpreted to mean that the value of the stock on an exchange must be used to determine if there is original issue discount.

If there is original issue discount on the convertible debt, what happens when the debt is converted into stock, and the corporation has been deducting the discount pro-rata over the life of the debt? Should prior deductions be "corrected" on the theory that later conversion eliminates the debt? The Service has held in a Revenue Ruling that if accrued interest was deducted prior to payment by the corporation, the corporation must correct its prior deduction at the time of conversion to the extent the prior deduction was of use to it. This approach is inconsistent with positions taken in analogous areas of the tax law. The fact that the corporation does not pay the interest in cash should be irrelevant; interest can be paid in stock. It would seem that when stock is


164. An interpretation which would maximize original issue discount in that fashion is out of keeping with earlier attempts to prevent a corporate deduction and investor evasion (see note 68 supra), but is in keeping with the recent shift towards taxing the investor (see note 74 supra). In Erie Lackawanna R.R. Co. v. United States, supra note 136 at 982-83, n.10, the court assumed without deciding that exchange price quotation established value, but the government denied that this was necessarily true.


166. Treas. Reg. § 1.483-2(b)(3) (1966); Treas. Reg. § 1.483-1(e)(3) (Example 2) (1966) involving contingent stock in an otherwise tax-exempt reorganization. See also § 305(c) (added by, Tax REFORM ACT § 421) which authorizes the treatment of pre-
issued by the corporation at the time of the conversion it is a payment of previously deducted interest, and no correction need be made. Perhaps the correction was required in the past because there was little hope of taxing the investor, and the correction was a method of capturing taxes lost at the investor level. If so, there is now less reason to use this approach since discount must be reported if the debt is registered.\textsuperscript{167}

d. Taxation upon Conversion

The exercise of a conversion privilege normally is not a taxable event. Exemption upon conversion pre-dates the statutory exemption for recapitalizations.\textsuperscript{168} In theory, the transaction was "open,"\textsuperscript{169} which appears to be another way of saying that the investment risk remained in the same assets. The reorganization provisions of 1921, which introduced an exemption for recapitalizations,\textsuperscript{170} might have provided an alternative basis for exemption. In the conglomerate acquisition context the choice of theory could make a difference in the taxation of accrued and untaxed original issue discount or dividend arrears to the seller at the time of conversion. The result is apparently in doubt.\textsuperscript{171} Exclusion by the seller might be justified as being within the scope of the reorganization provisions, which include economic incentives among the reasons for their existence; whereas a more arid "open transaction" analysis would result only in the exemption of the investment gain and not accrued income.\textsuperscript{172} It would seem that exclusion is inappropriate since the conversion of a senior security into a junior security would fit within the rationale of the

\begin{footnotes}
\item[167] See note 74 supra.
\item[168] The history is traced in Fleischer & Cary, supra note 166, at 476-96.
\item[169] Treas. Reg. 45, art. 1563 (1920).
\item[170] Revenue Act of 1921, § 202(c)(2), 42 Stat. 230.
\item[172] Other results which follow if only the reorganization approach is adopted include: (1) The need for a §367 ruling and (2) taxability upon the conversion of a short-term convertible debt. See Fleischer & Cary, supra note 166, at 491-92.
\end{footnotes}
recapitalization provisions only if the debtor were stepping down to equity status in a financially unstable corporation and not converting his debt to speculate in the equity of a growing company.\textsuperscript{173}

A second issue involves the treatment of the seller who elected the installment method when he received convertible debt.\textsuperscript{174} Does the normal rule exempting gain at the time of conversion prevail? The difficulty lies in the requirement that the creditor be taxed when the obligation is disposed of and the installment method was elected.\textsuperscript{175} Does it follow, however, that the investment gain inherent in the stock received at the time of conversion is received for the disposition of the debtor's obligation, just because the option to obtain stock is exercisable only with the debt? It would seem that gain in the conversion feature is no more a gain on the disposition of the obligation than it was an uncertainty in the value of the debt.\textsuperscript{176} The Code clearly requires only that the value of the obligation be taxed at the time of disposition. Since the value of the interest factor can be separated from face value for determining sale proceeds under the installment method,\textsuperscript{177} it seems equally appropriate to separate the conversion feature in order to limit the taxation on the disposition of convertible debt to the amount attributable to the obligation. It is true that the exercise of an option is sometimes taxed, but that result follows only when there is a major opportunity for tax avoidance, as in the case of compensatory stock options. Thus, if a compensatory option which does not qualify for exemption has an uncertain value, it is not taxed when received, but the price for deferral is a tax at ordinary rates on conversion.\textsuperscript{178} The avoidance of tax at ordinary rates on several elements of value is thereby prevented; \textit{viz.}, the option which was received at an earlier date,\textsuperscript{179} the increase in value due to personal services to the corporation whose stock is acquired; and the inside opportunity to buy the stock. There is no similar tax avoidance potential in the receipt of a conversion privilege when the installment sales provisions are elected.

\begin{itemize}
  \item \textsuperscript{173} Another difficulty with a recapitalization theory is that subsequent conversions might not be viewed as part of a plan of reorganization. \textit{See} Fleischer & Cary, \textit{supra} note 166, at 481-84.
  \item \textsuperscript{174} We assume now that the installment method was properly elected. \textit{See} note 158 \textit{supra}.
  \item \textsuperscript{175} \S 453(d) (1).
  \item \textsuperscript{176} \textit{See} text accompanying notes 158-60.
  \item \textsuperscript{177} \textit{See} text accompanying notes 69-71.
  \item \textsuperscript{178} Treas. Reg. \S 1.421-6 (1966) (nonstatutory stock options).
  \item \textsuperscript{179} In the context of restricted stock subject to conditions of forfeiture, \S 83(b) \textit{(added by the Tax Reform Act \S 321)} explicitly gives the taxpayer a choice. He may recognize the value of the stock at ordinary income rates when the stock is received and pay capital gains on later appreciation or he may pay ordinary income at a future date on both the value at the time of receipt and future appreciation when the restrictions are removed (\S 83(b)).
\end{itemize}
Its value is usually small and normally would have been taxed at capital gains rates anyway has there been no deferral.

2. Warrants

a. Effect on Tax-exempt Merger

Suppose the purchaser issues not convertible stock but instead issues voting stock and warrants. The Supreme Court has held that warrants are not voting stock, and so has prevented their use in otherwise exempt stock-for-stock and asset mergers. The Treasury has expanded this holding to assert that warrants are not equity, resulting in their taxation as boot in a statutory merger.

Treating warrants as non-voting equity might be supported on the ground that they are non-voting interests in the corporation for which the investor must commit additional resources to participate in warrant profits and that, therefore, they more closely resemble non-voting equity than a conversion feature attached to voting equity. This analysis would explain a recent Revenue Ruling which treated as property other than voting-stock a nontransferrable right attached to convertible voting preferred to acquire extra voting common for cash. While this conclusion seems plausible, its further extension to deny equity status to warrants is hard to understand.

One theory on which warrants might be denied equity status is that they, like preferred stock, present a serious bail-out potential because they are transferable. However, unlike preferred stock, the sale of the warrants could result in dilution of the seller’s interest if the buyer acquired stock. Another argument would demur to the point about dilution but assert that warrants will still be used as a convenient device to give investors a choice between cash and an increase in equity position. The development of this practice through the use of convertible preferred stock dividends has been dealt with in the Tax Reform Act by authorizing regulations to tax the convertible preferred when its distribution is likely to be used by investors to get cash in the short-run. However, in a corporate acquisition the acceptance of warrants would probably reflect a long term investment intent, especially if the potential dilution is significant and a significant cash outlay is required to obtain the stock pursuant to the option. Cer-

181. Treas. Reg. § 354-1(e) (1955). It is not clear what effect the receipt of warrants would have upon the continuity of interest requirement. In a close case, warrants might tip the scale in favor of exemption for the equity received.
182. See notes 16 supra and 185 infra.
184. See note 154 supra.
tainly the adoption of an inflexible position on warrants seems indefensible and is perhaps attributable to the fact that the detailed provision of section 306 dealing with preferred stock has obscured the bail-out problem. Perhaps the relevance of transferability will become apparent and the simplistic treatment of property other than voting stock as property other than stock will be re-examined when convertible voting equity, which is not considered solely voting equity because the taxpayer has a non-transferable right to acquire more stock for cash at the time of conversion, is used in a statutory merger and the Service claims there is taxable boot rather than exempt non-voting equity.

Case law is not entirely sympathetic to the Service's point of view. The court of appeals in dealing with spin-offs in Gordon held that warrants were equity in the context of section 355. In Bateman the court argued that the warrants did not have the effect of a dividend. The court felt that the logic of this conclusion should lead to treating the warrants as exempt equity, but the restraints of precedent prevented exemption, and the gain attributable to the value of the warrants was taxed as capital gain.

b. Effect on Installment Method

The problems presented by a conversion feature when electing the installment method are avoided if warrants are received. They are separately saleable and are, therefore, a second payment. As separate property, they are not thought to introduce an impermissible element of uncertainty into the proceeds even if they are hard to value. Warrants, therefore, have been desirable separate payments when the installment method is sought while convertibility is preferable when the exemption for a merger must be preserved.

c. Original Issue Discount

The only added dimension to the prior discussion of original issue discount, when warrants are involved, is the method of determining the amount of discount. It was noted earlier that when only the stock is traded on an exchange there was a problem in valuing the debt unless one assumes that the market value of the debt is equal to the price of the stock.

185. See note 183 supra.
188. We assume that if the stock is not traded on an established securities market both the debt and the warrants have to be so traded if there is to be original issue discount. See note 79 supra.
stock on the exchange thereby disregarding the possibility of a premium being paid for the stock. Even that assumption would be of no avail if both debt and warrants were issued. In such a case, the issue price for both debt and warrants is the value of the stock when the debt was first offered to the public; or if the debt is privately placed, the value of the stock paid by the first buyer. In order to determine the portion of issue price allocable to the debt, thereby determining if there is original issue discount, the issue price must be allocated to the debt. This allocation is made in the ratio of the debt's value to the value of both the debt and warrants. Valuing the debt is therefore inescapable if only the stock is traded on the exchange, even if one could avoid the problem when the stock is sold for debt without warrants by assuming that the issue price is the price of the stock traded on the securities market.

The Regulations state that if the debt is not easily valued because it is privately placed, an arm’s length agreement on the value of the debt will generally be followed as long as that value is based on an interest rate not more than one per cent greater than the stated interest rate. However, these Regulations, which minimize original issue discount, are out-of-date. They were issued before the new law prevented corporations from deducting interest under certain circumstances and required sellers to accrue the discount. The Regulations will presumably be amended to take account of this change of legal climate and, in the meantime, the requirement that the agreement determining original issue discount be "at arm's length" and that the agreement will "generally be followed" gives the needed leeway to prevent high bracket investors from minimizing the discount by agreement.

d. Taxing the Exercise of Warrants

The exercise of warrants is exempt for the same reason the exercise of a conversion privilege is not taxed: The investment risk remains in the same assets. The only basis for an exception would arise if the warrants were exempt upon receipt and the exemption was thought to have a tax avoidance potential. Even if warrants were exempt equity in a merger, however, their exercise should not be taxed since the potential for avoiding ordinary rates, present when compensatory options are used, is absent.
B. **Contingent Equity—Effect on Tax Exempt Merger**

What effect does the right to an increasing amount of equity, which depends upon future events, have on the tax exempt status of a merger? Several Service pronouncements assert that, if the contingent right is transferable and is readily marketable, then the right is taxable boot. So viewed, the right would destroy the exempt status of a stock-for-stock or asset merger and would be taxable boot in an otherwise exempt statutory merger. This view is reminiscent of the position taken on warrants. The non-equity classification has slightly greater plausibility in this context, however, since the likelihood of a sale to obtain cash in the short run is arguably greater in view of the contingency on which the future receipt of further equity depends. The conditions under which the Service apparently allows the use of transferable “escrow stock” without loss of exemption when the buyer wants to condition the consideration paid on future events, supports the suggestion that the bail-out potential explains the treatment of contingent equity not placed in escrow. Under an escrow arrangement, a third party holds the stock which is returned to the buyer if specified events do not occur. The Service argues that escrow stock is not boot only if the seller can both vote and receive dividends before the contingencies occur. This view makes sense if the logical basis for taxation of a contingent right to future equity is the likelihood of sale for cash. If there are voting rights and right to dividends, dilution of the seller’s interest would occur upon sale and the likelihood that the arrangement would be used to provide a bail-out potential is decreased.

Several other Service pronouncements specify further conditions which must be met if the stock received pursuant to the contingency is to be treated as part of the reorganization, but they are unclear whether failure to meet these requirements will result in taxing the right to the stock as boot or only in taxing the stock received at a later date as a dividend.

One such condition is that the stock must be payable within five years.

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196. Tillinghast, *supra* note 195 at 483 and 485. In Rev. Rul. 70-120, I.R.B. 1970-11, 15, the Service held that the imputed interest rules of § 483 did not apply to an exempt statutory merger in which non-transferable escrow stock was received, and the seller had dividend and voting rights. There is no suggestion, however, that non-transferability is a condition for exemption of the merger.

If failure to meet this requirement resulted in taxation of the contingent right as boot, the result would be irrational. If no bail-out problem exists, there is no reason to tax the right. The five year rule would, however, be reasonable if used to distinguish proceeds of a sale from stock dividends. Indeed, the new 1969 Regulations, which tax stock dividends payable "in all events"\footnote{198. Treas. Reg. § 1.305-3(b)(1) (1969). It is not clear whether § 305(c) (added by Tax Reform Act, § 421(a)) authorizes Regulations to deal with stock dividends payable in all events or only those stock dividends where the shareholder’s choice of property or stock is inererable.} on one of several classes of stock, do not apply if the stock is received as an adjustment of consideration within five years of a sale.\footnote{199. Treas. Reg. § 1.305-3(b)(4) (1969).} The issue which then arises is whether these Regulations supersede the Revenue Procedures applicable to contingent stock in light of the reference to "in all events." This phrase was probably intended to distinguish the case where the distributing corporation had discretion, not where objective conditions, such as future profits, determined the payment. Therefore, contingent stock payable over more than five years should be taxed under the new Regulations; contingent stock received over five years or less in connection with an exempt reorganization would be taxed only to the extent required by the imputed interest rules.\footnote{200. Treas. Reg. § 1.305-3(b)(4) (1969).} In neither case should a non-marketable right to contingent equity affect the exempt status of the earlier transaction in which the right was received. The validity of this analysis is supported by the fact that escrow stock which does not present the bail-out potential can apparently be used without destroying the exemption whether or not the contingency must be resolved within five years of the original transaction.\footnote{201. Murphy, supra note 195 at 281; Tillinghast, supra note 195 at 488.}

The Revenue Procedures also state that the contingent equity must be no more than fifty per cent of the total consideration. It has been suggested that this requirement was designed to insure a significant continuity of interest even if the contingency fails to materialize.\footnote{202. Tillinghast, supra note 195 at 210.} However, the absence of a requirement of significant continuity in the equity of the acquirer makes this explanation implausible. A more reasonable explanation of the fifty percent requirement is that the danger of disguised compensatory stock payments is increased if the contingent stock is a very large percentage of the consideration.\footnote{203. See Murphy, supra note 195 at 265.} Under this view, the rule is illogical if used to destroy the exemption upon a sale of stock since a taxable salary paid in stock for future services is no more received in exchange for stock than future imputed interest payments, the taxation of which...
does not affect the merger. However, the tradition of preventing tax avoidance on compensation might be extended to destroy the exemption of a merger when the contingent equity presents a risk that compensation will go untaxed. If this rationale were applied, the use of escrow stock should be equally vulnerable.

IV. TOWARDS REFORMING THE RULE-MAKING PROCESS

The common thread of criticism which runs through our observations of the rule-making process is that original premises remained unexamined. The malaise affects both the lawmaker and interpreter. Congress perpetuates the exemption for mergers and discourages acquisitions for debt without really knowing why. Rules dealing with the effect of conversion options on election of the installment method and with the effect of equity options and contingent equity on exempt mergers are fashioned as though the statute contained no underlying principles.

Recent consideration of rule-making has focused on the legislative process and particularly on the use of tax subsidies. However, concern with this problem has tended to wander off in a search for an ideal tax base instead of concentrating on the process which produces the perceived evil. This article, on the other hand, has viewed the problems of tax legislation and tax subsidies in relation to the rule-making process. Tax rules are made in various ways and the role played by Congress cannot be understood or reformed without examining the entire process. The conclusion suggested by our earlier discussion is that Congress' role in developing the tax law must be de-emphasized. First, Congress lacks

204. See text accompanying notes 178-79.

The more recent debate on “tax expenditures” has shifted towards concern with the legislative process. Bittker, Accounting for Federal “Tax Subsidies” in the National Budget, 22 NAT'L TAX J. 244 (1969); Surrey and Hellmuth, The Tax Expenditure Budget—Response to Professor Bittker, 22 NAT'L TAX J. 528 (1969); Bittker, The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth, 22 NAT'L TAX J. 538 (1969); Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 HARV. L. REV. 705 (1970). The major point has always been that a law which continually departs from an approach which has the “widespread loyalty that the Haig-Simons definition commands” deserves the closest scrutiny (the phrase in quotes is in Professor Bittker’s reply to Surrey and Hellmuth, 22 NAT'L TAX J. 538, 542 (1969)).
the ability to interpret the open spaces in the tax law. Thus, if the Treasury
had been allowed to develop continuity of interest rules, the statute on
corporate acquisitions might not have emerged in its current, highly
articulated and confused form. Second, coherent development of the
law combined with a presumption against Congressional action would
remove some of the motivation for tax legislation thereby creating an
atmosphere in which Congress could better examine the premises of the
law it is called upon to enact. For example, if the presumption had been
in favor of Treasury resolution of the equity-debt distinction and had the
statute been less cluttered, the attempt to pass hidden special legislation
to protect established companies from takeovers might not have sur-
vived Congressional scrutiny. Indeed, the reform of the legislative process,
which is a primary goal of those opposed to tax subsidies, will probably
have to await a broader reform of the rule-making process now that
public pressure for reform has been defused by the passage of the Tax
Reform Act of 1969.206

The prognosis for improving the rule-making process cannot be
optimistic.207 The Tax Reform Act continues the trend toward detailed
Congressional rules.208 Indeed, the new law successfully uses detail not

206. The failure of the American Bar Foundation to continue financing further tax
reform studies is symptomatic; 22 Tax Lawyer 53 (1968).
207. The Secretary of the Treasury seems to view the problem of statutory com-
plexity as resolvable by removing people from the tax rolls; complexity is all right in
his view if only tax advisors and accountants have to deal with the problem. Remarks of
Secretary of the Treasury Kennedy before the American Petroleum Institute, Houston,
Texas, Nov. 10, 1965 (at 5).

The Subcommittee on Legislative Regulations of the Tax Section of the American
Bar Association provides a ray of hope. It suggested that "the proper direction for tax
legislation is toward more generalized statutes with more emphasis on policy and objec-
tives and less on the rules of detailed application." 21 Tax Lawyer 973 (1968). The
Tax Section changed the recommendation to read: "The proper direction for tax legis-
lation is toward more emphasis on policy and less on detail"; 22 Tax Lawyer 18 (1968).
It is not clear whether the Tax Section was applying its principal of "less detail" in
changing the wording or was disagreeing with its subcommittee.

208. In view of earlier comments on the potential role of judicial and Treasury in-
terpretation in forestalling detailed Congressional "solutions," it is discouraging to note
several areas of "reform" which could have been avoided by courts or the Treasury. For
example, the new law on bootstrap sales (§§ 514 & 1253, added by, Tax Reform Act §§
121(d), 516(c)), might have been avoided if transfers to charity for consideration which
depended solely upon the profitability of the transferred property had not been treated as
a sale (Commissioner v. Brown, 380 U.S. 563 (1965)), or the effect of such transfers on
the charity's own tax posture had not been favorable (University Hill Foundation, 51
T.C. 548 (1969)). The entire subject of private foundations might have been avoided in
the new tax law (§§ 507-09 & 4940-48, added by, Tax Reform Act § 101) if Learned
Hand's suggestion that exemption for such conduits was not within the statute's purpose
had been listened to thirty years ago (Havemeyer v. Commissioner, 98 F.2d 706, 707-08
(2d Cir. 1938) (dissenting)).

The need for the "excess deductions account" rules (§ 1251, added by, Tax Reform
Act § 211(a)) might not have developed if the Regulations allowing farmers to deduct
expenditures which other taxpayers must add to cost had been modified so that only
merely to confuse the reader but also to conceal the limited nature of the reforms. One example of limited change, hidden in a web of detail, is the minimum ten per cent levy on “tax preference” income.\textsuperscript{209} The tax base for the minimum tax is reduced by the regular income tax.\textsuperscript{210} This reduces the effective minimum tax rate below ten per cent, which reduction \textit{increases} as the taxpayer’s tax bracket rises.\textsuperscript{211} Similarly, the new hobby loss rules not only end up restating the case law, but also create a presumption \textit{for} the taxpayer.\textsuperscript{212}

These remarks should not be confused with a blind faith in the ability of the Treasury and of the Service, rather than the legislature, to develop the law rationally. Much of this article is a criticism of results reached by courts and the administration. Judicial failure is most apparent in developing continuity of interest rules.\textsuperscript{213} Part III suggested that Treasury Regulations have erred in treating warrants as boot\textsuperscript{214} and that the Service has made a jumble of the taxation of interest paid in stock\textsuperscript{215} and of the rules on contingent equity.\textsuperscript{216} Still, the potential for effective rule-making is greater outside of Congress, and improvements in rule-making cannot precede without a move in that direction.

Although hard thought remains a major ingredient in interpreting any law, there are a number of institutional modifications which could improve the effectiveness of the judiciary and the administration as rule-makers. Suggestions for a Court of Tax Appeals have, in part, been based on a desire to improve the courts’ role in developing tax law.\textsuperscript{217}

\begin{footnotes}
\footnote{209. §§ 56-58, added by, \textit{TAX REFORM ACT} § 301(a).}
\footnote{210. § 56(a)(2), added by, \textit{TAX REFORM ACT} § 301(a).}
\footnote{211. Assume a taxpayer earns one hundred dollars taxed at a sixty per cent effective tax rate. If he earns another two hundred dollars of exempt tax preference income, his total tax without the ten per cent minimum tax is sixty dollars. One might think that the new law imposes not only a sixty dollar tax on the first one hundred dollars, but an additional twenty dollar tax (i.e., ten per cent of two hundred dollars tax preference income) for a total of eighty dollars. However, the sixty dollar regular tax is subtracted from two hundred dollars and the added tax is only fourteen dollars (ten per cent of 140 dollars). If the taxpayer’s regular effective tax rate is seventy per cent, the minimum tax declines to thirteen dollars. (The example disregards the 30,000 dollar floor on items of tax preference income subject to the ten per cent tax).}
\footnote{212. § 183, added by, \textit{TAX REFORM ACT} § 213.}
\footnote{213. \textit{See} text accompanying notes 9-15 \textit{supra}.}
\footnote{214. \textit{Supra} note 181.}
\footnote{215. \textit{See} text accompanying notes 165-66.}
\footnote{216. \textit{See} Part IIIB of text.}
\end{footnotes}
RULE-MAKING PROCESS

However, while such changes would be useful, the major focus of any shift from an emphasis on legislative rule-making will have to be on improving the administrative rule-making process. The following comments develop the thesis that a reduction in the weight afforded published rulings and an expansion of the Regulations program give the greatest hope for such improvement. We first discuss the rulings program and then turn to Regulations.

Published rulings currently enjoy a dignity not justified by the process by which they are developed. They emerge from the Office of the Assistant Commissioner (Technical) after review primarily by "technical specialists" who are not usually attorneys. There are uncertain indications that further review takes place in the Interpretative Division of the Chief Counsel's office, but the evidence indicates that the job is treated with a lack of urgency. Treasury review is practically non-existent before publication. There is no public notice or hearing prior to publishing a ruling. Despite these shortcomings, however, the Service states that taxpayers "generally may rely" upon published rulings and that revocation, if it occurs, will "ordinarily" be prospective. The Service thereby perpetuates rules which have defects similar to the tax laws

count led to § 1232 of the Internal Revenue Code of 1954. If United States v. Midland-Ross Corp., 381 U.S. 54 (1965), had been decided by a Court of Tax Appeals before the 1954 Code, the need for statutory elaboration to resolve doubts might not have developed.

218. An example of a Treasury Regulation which develops rules in an area where courts are reluctant to act is Treas. Reg. § 1.1375-1(d) (1959), holding that the capital asset status of property owned by a Subchapter S corporation is determined by reference to the activities of "substantial" shareholders and other Subchapter S corporations in which they are shareholders. In Braunstein v. Commissioner, 374 U.S. 65 (1963), the Court refused a request to make such inquiries in the collapsible corporation area.

219. See generally Shapiro, The Choice of Rulemaking or Adjudication in the Development of Administrative Policy, 78 Harv. L. Rev. 921 (1965). Our concern is with the choice between rule-making by regulation, and rule-making by published ruling.

220. This phrase is borrowed from L. Wright, Comparative Conflict Resolution Procedures in Taxation 65 (1968) (hereinafter cited as Wright).

221. This task does not appear explicitly in the description of the Interpretative Division's functions; Statement of Organization and Functions of the Internal Revenue Service at § 1113.(10)22, reprinted in, 34 Fed. Reg. 1680 (Feb. 4, 1969). In 1964 review by the Chief Counsel's Office was explicitly limited to "the most important or complex rulings" (I.R.S. News Release, May 21, 1964, 647 CCH § 6610). Wright at 52-53, n.146 says that such review is "usual." Rogovin, The Four R's: Regulations, Rulings, Reliance and Retroactivity, 43 Taxes 756, 766 (1965) (hereinafter cited as Rogovin) says it is "formal or informal." See also Caplin, Taxpayer Rulings Policy of the Internal Revenue Service: A Statement of Principles, 20 N.Y.U. Tax Inst. 1, 28 (1962) (hereinafter cited as Caplin).

222. Wright at 31.

and which hardly provide a reasonable alternative to Congressional rule-making.

Confusion is common. Reference has already been made to the rules on contingent equity and convertible stock, but other examples can be cited. It took three published rulings to "clear up" the deductibility of mortgage points, but the law remains uncertain.224 No one understands why the Service ruled that expenses to secure, but not to seek, a job are deductible.225 And anyone who thinks "home" always means "business home" should consider the Revenue Ruling dealing with construction workers.226 Published rulings also open up unintended loopholes. Industrial revenue bonds227 and foreign actors228 have been beneficiaries of such rulings despite the fact that the statute could easily bear contrary interpretations. Furthermore, the problem is not merely one of past mistakes only prospectively corrected. Since a published ruling binds

224. The Service first ruled that interest prepayments might not be deductible when the deduction would distort income; Rev. Rul. 68-643, 1968-2 CUM. BULL. 76. It then stated that mortgage points could be deductible. Rev. Rul. 69-188, I-R.B. 1969-16, 8. Someone must have then realized that mortgage points are prepayments and that a conflict with the prior ruling might exist. The Service, therefore, ruled that mortgage points of 1200 dollars paid on a loan of 20,000 dollars were deductible when incurred. Rev. Rul. 69-582, I-R.B. 1969-47, 8. However, this last ruling does not explain whether it is based on the amount of the payments and the loan or whether all prepayments in the form of mortgage points are deductible. The first ruling listed many criteria for identifying deductible prepayments, including both the amount and purpose of the payments, but the last ruling is silent as to its rationale.

225. Rev. Rul. 60-158, 1960-1 CUM. BULL. 140; Rev. Rul. 60-223, 1960-1 CUM. BULL. 57. The Service has never explained why expenses of securing employment are not capital expenditures, if the taxpayer is seeking his first job, nor why expenses to seek the first job are not deductible losses when the effort fails. The fact that the taxpayer has not yet begun his income-producing venture should be irrelevant since his purpose is to make a profit. See Primuth v. Commissioner, 54 T.C. No. 36 (1970), which might initiate some rational development of this area.


227. Rev. Rul. 54-106, 1954-1 CUM. BULL. 28. Surely the obligations of a government need not include debts for which the government's credit is not pledged.

228. Rev. Rul. 54-119, 1954-1 CUM. BULL. 156 interprets the exemption for industrial and commercial profits of a foreign corporation which is found in many of our income tax treaties (see, e.g., Convention and Protocol Between the United States and Canada Respecting Double Taxation, March 4, 1942, 56 Stat. 1399, T.S. No. 983) to include payments for the services of an entertainer without limiting the exemption to cases where the employee is not an owner of the corporation, although it could have been easily limited to such cases. The salary to the owner-employee is often exempt if the entertainer limits his stay in the United States. (Id. at art. VII(1)(a)). A personal holding company tax and a tax on the dividends paid by the corporation are impossible to collect. Section 482 is available to tax the entertainer (Borge v. C.I.R., 405 F.2d 673 (2d Cir. 1968), cert. denied, 395 U.S. 933 (1969)), but collection remains a problem. The United States-Japanese Income Tax Treaty, contains a detailed provision to close the loophole. Convention with Japan Respecting Double Taxation, arts. II(1)(i)(ii)E, IX(2), CCH TAX TREATY REP. ¶ ¶ 4405, 4412 at 4407, 4409-2, -3.
agents as a matter of internal housekeeping, and officials issuing private rulings are not likely to question a published ruling's validity, administrative practice builds up easily around a published ruling. The ruling then serves as weighty evidence of long-standing administrative practice and makes prospective change more difficult, both legally and politically.

Why are published rulings afforded such dignity if they are an inferior form of rulemaking? We will first look at the court's approach to these Service pronouncements in the cases dealing with equal treatment of taxpayers and with protection of a reliance interest to see whether they require or encourage this result. After inquiring into judicial attitudes we will comment on factors perceived by the Service which might explain its views. Our discussion of published rulings will then conclude with some suggestions for reducing their stature.

Equal treatment of taxpayers is a problem whenever a published ruling is retroactively revoked since revocation routinely involves some inequity. Numerous taxpayers will be treated differently from certain categories of taxpayers who will automatically be granted an exception from the effect of revocation, such as those who received and relied on private rulings, those whose cases were closed after audit, and those for whom the statute of limitations has run. Furthermore, even a prospect-

231. In 1969, the Treasury tried to revoke Rev. Rul. 54-106, 1954-1 CUM. BULL. 28 and some of its progeny dealing with industrial revenue bonds (see Proposed Treas. Reg. § 1.103-7, 33 Fed. Reg. 4950 (March 23, 1968)). The effort met with vigorous opposition. A statute finally revoked some of the benefits, but only in a complex fashion which preserved exemption in numerous situations in which communities had grown to depend upon the economic activity approved by the published ruling; § 103(c), added by, Pub. L. No. 90-364, § 107(a).
232. The Service's announced policy as to private rulings issued directly to a taxpayer (sometimes referred to as "letter rulings") is to revoke them prospectively except in "rare or unusual circumstances" if the taxpayer relies upon the ruling when engaging in a transaction. Treas. Reg. § 601.201(1)(5) (1969).
233. The Service states that it does not open cases closed after audit to a taxpayer's detriment unless there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact, a clearly defined substantial error based on an established Service position existing at the time of the previous examination or if other circumstances exist which indicate that failure to reopen would be a serious administrative omission. Treas. Reg. § 601.105(j)(1) (1969); furthermore, cases closed by mutual concessions will only be reopened for fraud, malfeasance, concealment or misrepresentation of material fact, or an important mistake in mathematical calculation; Treas. Reg. § 601.106(h)(1) (1969).
234. §§ 6501 and 6503.
tively revoked ruling discriminates against those who failed to enter a transaction prior to the date of revocation.

The concern of courts with equal treatment has recently been placed in sharp focus by the IBM case, which both illuminates the limitations on using considerations of equal treatment in federal tax cases and suggests that such considerations should normally place no obstacle in the way of revoking published rulings. In IBM the taxpayer successfully complained that its major competitor received a ruling whereas it was denied a ruling on the same facts after a long delay. The IBM case properly approaches equal treatment as part of the larger question of whether the agency has abused its discretion. The search, therefore, is not merely for inequity, but for inequity which results from improper administrative behavior. When approached in that manner, the appropriate tasks are to identify the burden of the inequity on the aggrieved party and the manner of administrative behavior leading to that result. With regard to the burden on the taxpayer, the IBM case deals with the very special problem of unequal treatment of the only two large competitors in a market. When published rulings are revoked, such inequity will rarely be presented. Furthermore, the equal treatment of taxpayers who are in similar legal positions without regard to the accuracy of the result raises legitimate objections from the much larger group of taxpayers who must pay the correct tax.

If we look at the behavior of the administration in the IBM case,

236. Id. at 920. See also Dixon v. United States, 381 U.S. 68, 80 (1964). The statutory base for inquiring about an abuse of discretion is said to be § 7805(b) which authorizes prospective revocation of rulings. However, this section was intended to expand the Treasury's power which was at one time thought analogous to a court's power to interpret the law only with retroactive effect (Wright at 17). It would be better to recognize that behavior found to be an abuse of discretion generally falls outside an official's statutory authority in the absence of explicit provisions to the contrary.
237. The element of discrimination among major economic competitors might explain IBM, without regard to the further element of administrative abuse. Bookwalter v. Brecklein, 357 F.2d 78, 83 (8th Cir. 1966); Bivens v. United States, 345 F.2d 558, 564 (Ct. Cl. 1965); Shakespeare v. United States, 389 F.2d 772, 777 (Ct. Cl. 1968).
See also City Loan and Savings Co. v. United States, 177 F. Supp. 843 (N.D. Ohio 1959), aff'd on other grounds, 287 F.2d 612 (6th Cir. 1961) in which discrimination between the only two competitors was not allowed after the Commissioner had published his acquiescence in a case involving one competitor.
238. While we have not been accustomed to comparing all taxpayers to each other, the publicity given to "tax subsidies" (see note 205 supra) may develop in the public a belief that one man's tax reduction means that another taxpayer must make up the difference. Cf. Commissioner v. Sunnen, 333 U.S. 591, 599, 602-03 (1948), in which the government was able to reopen an issue previously decided after litigation despite a claim of collateral estoppel, in part because a contrary result would accord the taxpayer "a tax treatment different from that given to other taxpayers of the same class."
we find that the branch in the national office which issued rulings knowingly discriminated against IBM by rejecting its request for a ruling and delayed for some time before responding to the request. We do not suggest that "conscious discrimination" and delay will, of themselves, always constitute an abuse of discretion by an agency. The important point is that by citing these factors the court properly sought to determine whether the administration acted arbitrarily and not merely to identify unequal treatment.

In the context of published rulings, therefore, the question is whether the unequal treatment resulting from the routine exemptions to their revocation described above is the product of impermissible administrative behavior. In our view, the reasons for the routine exemptions are all based on criteria which administrations can legitimately consider. First, the exceptions for cases closed on audit and barred by the statute of limitations are the natural result of a decentralized enforcement process. The volume and geographical diversity of work require selectivity in the audit process and make uniformity of decision-making impossible. When the Service accepts the consequences of this process by treating the results as final upon revoking a published ruling and refuses to extend those benefits to those who have not been favored by the decentralized decision-making process, it is not acting arbitrarily. If the Service's actions were considered as an abuse of discretion when it applied a reasonable rule of finality, all diverse decisions would be objectionable. A decision on audit in the New York office or in a private ruling from the

239. 343 F.2d at 916-17.
240. The phrase appears in Wagner v. United States, 387 F.2d 966, 972 (Ct. Cl. 1967).
241. If non-uniformity is the result of failing to use reasonable techniques to eliminate it, administrative disregard of the problem might be as impermissible as "conscious discrimination." Recent cases in which unequal property tax valuations have been found impermissible are examples: In re Appeal of Kents, 34 N.J. 21, 28-30, 166 A.2d 763, 767-68 (1961); Hamn v. Minnesota, 255 Minn. 64, 70-71, 95 N.W.2d 649, 654-55 (1959); In re Brooks Building, 391 Pa. 94, 98-102, 137 A.2d 273, 275-76 (1958). However, the Service already does a very defensible job of review and post-review to try to prevent whimsical decision-making from becoming institutionalized.

The needs of administration emerged as an excuse for unequal treatment in Bookwalter v. Brecklein, 357 F.2d 78, 83 (8th Cir. 1966), where the prospective revocation of a private ruling was justified on administrative grounds against a claim of inequity by a similarly situated taxpayer who did not receive a ruling. Cf. Barr v. C.I.R., 51 T.C. 693 (1969) (disallowance of a deduction for personal exemptions for non-citizen dependents was justified because of the difficulty of administrative verification).

242. There is even a hint in some cases that a case closed on audit, not only cases on which the statute of limitations has run, must remain closed; see, e.g., Guggenhein v. United States, 77 F. Supp. 186 (Ct. Cl. 1948), cert. denied, 335 U.S. 908, rehearing denied, 336 U.S. 911 (1949) (predecessor of Form 870-AD binding); Vestal v. C.I.R., 152 F.2d 132 (D.C. Cir. 1945) (Service not allowed to adopt a litigating position inconsistent with earlier position on same transaction).
national office would have to be applied to a California resident on audit. We do not expect such uniformity from our court system and it is hard to see why we should require it from the Internal Revenue Service. Such a requirement would be false to the emphasis in the *IBM* case on the taxpayer's application for a ruling, which established that its different treatment resulted not merely from a decentralized audit process but from a conscious distinction made by one office which was capable of reviewing its official decisions to prevent unreasoned variation.243

A second routine exception from the effect of a revoked published ruling is made for the recipient of an earlier private ruling. However, the decision by the agency to defer to a taxpayer's reliance interest by honoring its promise not to revoke a private ruling except in rare and unusual circumstances,244 despite its decision to revoke a published ruling which does not carry such a promise, cannot be labeled arbitrary. Indeed, we will soon examine some cases which suggest that reneging on such a promise is itself some evidence of arbitrary action.245

Finally, revocation of a published ruling either prospectively or retroactively is usually the result of a developing view of the law. As long as the change is explained as a consequence of that process, those affected by the resulting change uniformly applied, except as to taxpayers benefitting from administrative considerations of finality and reliance, cannot legitimately complain of arbitrary agency action.246

A second line of cases which has obvious relevance for the stature of published rulings deals with holding the Service to its statement of the law. It would be a mistake, however, to assume that these cases are a mechanical protection of a reliance interest any more than the *IBM*

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243. Several cases after *IBM* found the failure to apply for a ruling a basis for distinction; Bornstein v. United States, 345 F.2d 558, 564 (Ct. Cl. 1965); Van Norman Industries, Inc. v. United States, 361 F.2d 992, 999 (Ct. Cl. 1966), *cert. denied*, 386 U.S. 981 (1967); Shakespeare v. United States, 389 F.2d 772, 777 (Ct. Cl. 1968).

In Bookwalter v. Brecklein, 357 F.2d at 82 and 84, the court emphasized the fact that no ruling had been applied for, although it failed to emphasize that the same district office to which the taxpayer had addressed his request for a refund prior to the Service's change of position had issued a favorable determination letter to another similarly situated taxpayer. *Id.* at 80-81....

But see Knetsch v. United States, 348 F.2d 932, 940-41 (Ct. Cl. 1965), in which the court seemed willing to consider a claim of unequal treatment among taxpayers who had not received a private ruling.

244. See note 232 supra.

245. See text accompanying notes 247-48 infra.

246. On the other hand, the retroactive application of a new interpretation only as to those who have not paid their taxes is impermissible; Connecticut Ry. and Lighting Co. v. United States, 142 F. Supp. 907 (Ct. Cl. 1956); Exchange Parts Co., Inc. v. United States, 279 F.2d 251 (Ct. Cl. 1960). This requirement that substantive agency rule-making make rational distinctions is most comprehensively developed in Justice Frankfurter's concurring opinion in *Kaiser v. United States*, 363 U.S. 299, 305-25 (1960). See also United States v. Catto, 384 U.S. 102, 115-16 (1966).
case is a simple application of equal treatment considerations. The question, as before, is whether the Service has abused its discretion. The American Plywood case illustrated this point clearly. The taxpayer was an exempt business league which arguably had engaged in some activities which went beyond the purposes for which it received exempt status. The Service decided that these activities were not "incidental" and retroactively revoked the private ruling granting exemption. The court, in an alternative holding which was later deleted from the officially reported opinion, refused to rely on estoppel to bar the government's action, but found retroactive revocation without notice an abuse of discretion. In finding abuse, the court emphasized that the Service's own internal rules forbade retroactive revocation of a private ruling except in rare or unusual circumstances. Apparently, the reliance interest in private rulings and in the Service's published revocation policy does not deserve protection by itself, but a departure from internal agency standards where a reliance interest exists might be an abuse of discretion. In taking this approach, the court aligned itself with a developing body of cases which refuse to permit a departure from agency rules where the potential loss to the aggrieved party is great and departure from the agency rule presents a serious risk of arbitrariness.

There are several other elements in American Plywood which accentuate both the significance of the loss and the risk of arbitrariness resulting from the Service's interference with a reliance interest. First, the court emphasized the special place of exempt organizations in our society and the contributions of the taxpayer to the public good. Second, the


248. The following cases, which all involve rules embodying an agency's own version of a fair hearing, are illustrative:


Military Law: Smith v. Resor, 406 F.2d 141 (2d Cir. 1969) (order to reservist to report for active duty improper when Army did not follow its procedures for review of company commander's order).

Cf. Greene v. McElroy, 360 U.S. 474 (1959) (revoking security clearance resulting in loss of job is beyond agency's authority if no opportunity to cross-examine).

See also Heffner v. United States, 70-1 U.S. TAX CAS. ¶ 9152 at 82,657 (4th Cir. 1969), in which the court held the I.R.S. bound to give the Miranda-type warnings required by its own rules. The court did not care that the public notice and hearing procedures of the Administrative Procedure Act had not been followed in adopting the rules or that the warnings might not be constitutionally required.

249. 67-1 U.S. TAX CAS. ¶ 9245 at 83, 528. In Lesavoy Foundation v. Commissioner, 238 F.2d 589 (3d Cir. 1956) the special place of exempt organizations in the tax law emerged clearly. Despite an admitted confusion in the law involving the relevance
court noted the "judgmental" quality of the decision which was reversed; i.e., whether activities were "incidental" thereby suggesting the capriciousness of the Service's action. Several other cases which have held the Service bound by its private rulings have also involved reversals of judgment about the application of legal standards to facts.\textsuperscript{250} Of course, such reversals need not be capricious\textsuperscript{251} if the reversal is based on a changed view of the legal standards to be applied. However, since the injection of additional standards or the re-alignment of the weight of the standards used in making a judgment shades imperceptibly into a reversal of judgment\textsuperscript{252} the absence of an explanation by the agency indicating that its decision is more than simply a reversal of judgment can legitimately be considered evidence of capriciousness. An explanation would also make clear that the changed view is one which could have been anticipated and, therefore, protected against by competent legal counsel.

If the taxpayer's "reliance interest" is analyzed in the above fashion, there is little opportunity to find an abuse of discretion upon revocation of published rulings. First, the internal agency rule on revocation of published rulings allows more discretion than in the case of private rul-

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\textsuperscript{250} Woodworth v. Kales, 26 F.2d 178 (6th Cir. 1928) (value of stock); H.S.D. Co. v. Kavanaugh, 191 F.2d 831, 845-46 (6th Cir. 1951) (was an employee's trust nondiscriminatory and for the exclusive benefit of employees?). The Supreme Court in Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957), characterized these cases as not involving "mistakes of law," thereby suggesting that mistakes of fact cannot be retroactively corrected.

\textsuperscript{251} Cf. Dixie Furniture Company v. C.I.R., 390 F.2d 139 (8th Cir. 1968), in which Judge Blackmun stated that differences of opinion among different revenue agents as to what is a "reasonable" bad debt reserve in different years was not an "abuse of discretion" and was part of the "way of life in tax law," even if the facts were unchanged.

\textsuperscript{252} The Supreme Court, in Dixon, 381 U.S. at 76, characterized the Service's action in Automobile Club of Michigan as a correction of a "mistake of law"; in the latter case, the factor of "fellowship" in identifying an exempt club had not been considered relevant for tax years prior to the effective date of the revocation of the ruling. \textit{Cf.} Commissioner v. Sunnen, 333 U.S. 591, 606 (1948) in which a "change in the legal climate" prevented a taxpayer from using collateral estoppel as a defense.
RULE-MAKING PROCESS

ings²⁵⁸ thereby reducing the reliance interest and enlarging the boundaries within which the agency can act before a departure can be found arbitrary.²⁵⁴ Second, since the power to revoke rests only with the national office, not enforcement officials,²⁵⁵ the risk of capriciousness in the exercise of discretion is reduced. Third, published rulings rarely involve the special interests which exempt organizations arguably possess. And, finally, although published rulings frequently involve judgments based on facts,²⁵⁸ the relevant legal considerations are often articulated so that it is easier to explain a reversal.

There is one limited situation, however, in which the Supreme Court's analysis of abuse of discretion has apparently given weight to a taxpayer's reliance interest in a published ruling. Ironically the suggestion appears in the Dixon case,²⁵⁷ which emphatically refused to protect this interest.²⁵⁸ However, when the court turned to deciding whether there was an inequity which amounted to an abuse of discretion in the revocation of a published ruling, it seemed to consider the reliance interest,²⁵⁹ which, by itself, had been found too insignificant to support the taxpayer's claim. The Service had ruled publicly that original issue discount was entitled to capital gains treatment upon the redemption of certain types

²⁵³. See notes 223 (published rulings) supra and 232 (private rulings) supra.

²⁵⁴. Some cases dismiss internal agency rules as "directory" not "mandatory" (Luhring v. Glotzbach, 304 F.2d 560, 565 (4th Cir. 1962) (Service rule providing for hearing before Appellate Division)) or "self-serving" (United States v. Jaskiewicz, 278 F. Supp. 525, 537 (E.D. Pa., 1968) (Service policy not to assess taxes if criminal prosecution is likely)), thereby suggesting that a departure from a rule not intended to benefit the public is always permitted. This approach has only limited validity. An agency's own "expert" views of what protection the public needs is relevant in deciding how important it is to prevent a departure. But the ultimate issue is whether the failure to adhere to the rule is an abuse of discretion and this need not depend upon whom the agency thought its rule benefited. Furthermore the agency's motives are often mixed. Thus, published rulings are generally adhered to both to maintain public relations and to protect the taxpayer's reliance interests.


²⁵⁶. See, e.g., Rev. Rul. 69-388, I.R.B. 1969-28, 17, holding a foreign tax to be "in lieu of" income taxes. Sometimes it is stated that a published ruling is a "general" statement as opposed to an "individualized" private ruling; Bookwalter v. Brecklein, 357 F.2d at 86. However, this dichotomy refers to the difference in the invitations to rely, not to the presence of legal or factual elements in the opinion. A similar line was drawn in Shotwell Mfg. Co. v. United States, 371 U.S. 341 (1963) in distinguishing a published policy not to prosecute taxpayers who voluntarily disclose their fraud from an individualized inducement to confess.


²⁵⁸. Id. at 76. The case involved an acquiescence. However, since the acquiescence had been published in a Revenue Ruling (Id. at 71, n. 2), the Court made no distinction between an acquiescence and a Revenue Ruling.

²⁵⁹. Id. at 76-80.
of certificates which represented indebtedness. When it revoked the ruling it did so retroactively except as to the redemption of those certificates. Taxpayers who had sold other types of debt complained of inequity in the retroactive application of the revocation. The Court asked, not whether sales by the complaining taxpayers were like redemptions, but whether the taxpayers were "warranted in reading" the published ruling to apply to sales.260 Although the Court found such a reading unwarranted, the reasonableness of reliance on a published ruling was apparently relevant in deciding whether there was an abuse of discretion when the Service distinguished between those whom it viewed as the "core" case and the taxpayers, who also saw themselves within the intention of the revoked ruling.

The foregoing suggests that despite hints in some cases the stature of published rulings is not the result of judicial encouragement or judicial compulsion. Furthermore, whatever judicial attitude there is to the contrary seems influenced by the Service's own internally adopted rule which invites taxpayers to rely on the breadth of coverage of a ruling. The Service, therefore, can minimize these factors by withdrawing or weakening its invitation to rely and by drafting its rulings more narrowly.

Nothing we have suggested is intended to urge that rulings not be published. Publication serves an important function beyond the question of whether the publication is binding on the agency. Historically, publication was intended to prevent private rulings from favoring taxpayers secretly thereby protecting the integrity of the private ruling process.261 An analogous reason for publication is to enable public comment to be made on tentative Service positions. However, these reasons lend no force to the idea that published rulings should be binding. The whole point would be to encourage critical scrutiny by the public of private rulings to see if there was error.

Another reason for publishing rulings is to alert taxpayers to those

260. Id. at 78. There is also a hint in Bookwalter v. Brecklein, 357 F.2d at 82, that reliance is relevant when the only unequal treatment is between recipients of rulings and those who have not applied. On the other hand, the Supreme Court in Dixon later asked whether the taxpayer's debt could "rationally be distinguished" from the debt held by the benefited taxpayers (Id. at 79), not whether the aggrieved taxpayer was "warranted in reading" the ruling to apply to his debt.

261. Wright at 19-20, 54. Pressure to publish rulings built up in the early 1920's when significant pressure was also brought to publicize tax returns to prevent fraud. See R. Paul, Taxation in the United States 136 (1954). In 1924, Congress imposed the requirement that the names of taxpayers and the amount paid be published; Revenue Act of 1924, § 257(b), 43 Stat. 293. The current provision (§ 6103(f)), requiring only that names of taxpayers be available to the public, was passed in 1926; Revenue Act of 1926, § 257(e), 44 Stat. 51.
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Service positions which are binding on enforcement officials as a matter of internal housekeeping so that there can be an intelligent discussion of a case with an agent, instead of shadow-boxing in which the taxpayer does not know what issues he should really be discussing.\textsuperscript{262} It also furthers uniformity by enabling taxpayers to urge all relevant arguments on the agent. Once publication serves this function, however, it becomes important that the rule not publicize a mistake made in a private ruling lest it be repeated countless times throughout the country by agents. The potential magnitude of an error results in the published rulings program pushing for accuracy and coherence,\textsuperscript{263} not just public disclosure, but this does not mean that the publication need be binding on the Service itself.

There might be some confusion about whether publication urges that an agency be bound by its own rulings because of the Service's announced position that agents cannot rely on unpublished positions\textsuperscript{264} and the provision in the Freedom of Information Act which prevents reliance by the agency to an individual's detriment on "interpretations of general applicability" unless they have been published.\textsuperscript{265} However, these rules limiting the weight of unpublished statements do not suggest that published positions should be binding. The prohibitions against reliance on unpublished rulings are sanctions which suggest nothing about the effect of...

\textsuperscript{262} The requirement that a taxpayer be told when an agent asks for technical advice serves a similar purpose; Rev. Proc. 69-2 § 4.02, 69-1 I.R.B. 12.

\textsuperscript{263} Wright (at 54) notes the tension between the need to publish to prevent favoritism and the need to publish only accurate interpretations.

\textsuperscript{264} See fly-leaf to 1968-2 Cum. Bull. (p. xxvii). But see Bookwalter v. Brecklein, 357 F.2d at 81, where there is evidence that private rulings are relied on by district offices.

\textsuperscript{265} 5 U.S.C.A. § 552(a) (1) (D) (1966). We are not now concerned with what the Freedom of Information Act requires the Service to publish but only with whether the rule which prevents an agency from relying on unpublished rules has any implications for the effect of publication.

One might ask what effect a sanction of nonreliance can have on "interpretations of general applicability." The sanction is meaningless unless interpretative material has weight. If later suggestions are adopted, viz., that the distinction between legislative and interpretative regulations is often ephemeral (see text accompanying notes 283-301 infra), then the sanction can operate upon the reliance which courts would place on interpretative material. It might also reduce the weight courts would give to administrative practice embodied in statements which the law requires to be published but which are not. On the other hand, the sanction might only operate on the agency's use of inadequately published interpretations in administrative adjudications (cf. NLRB v. Wyman-Gordon Co., 394 U.S. 759 (1969)). In any event, even if the sanction of nonreliance is of little significance, items which must be published can apparently be obtained by court order; 5 U.S.C.A. § 552(a) (3) (1966).

The Service argues that only rulings applied as precedents by the Service need be published. Treas. Reg. § 601.702(b) (1) (1967); Uretz, Freedom of Information and the IRS, 20 Ark. L. Rev. 283 (1967). Davis, The Information Act: A Preliminary Analysis, 34 U. Chi. L. Rev. 761, 772-75 (1967), argues that the sanction of non-reliance by the agency does not limit the rules which must be published to those on which the agency relies. He asserts that private rulings must be published.
publication. As noted above, the sanction might be imposed to reveal error, not to perpetuate it. Furthermore, the history of Congressional pressure on the Service not to bind agents to unpublished rulings suggests only that Congress was threatening to take away a desirable tool of internal management in order to force publication, not that the publication must bind the Service.\footnote{266. Wright at 67.}

Willingness by the administration to be bound by its published rulings cannot, therefore, be explained as an outgrowth of either the rule-making process, the development of case law requiring agencies to treat people equally and to follow their own procedural rules, or as a natural consequence of publication. The dignity of published rulings, despite the risks earlier alluded to, results instead from an administrative imperative felt to a considerable degree by the Internal Revenue Service. The public's perception of what is equitable treatment and what publications should be reliable exceeds that which a court is willing to require, and the Service's sensitivity to the public's image of the tax collector has lead the administration to avoid anything which smacks of capriciousness. For this reason, the Service gives much greater weight to published rulings than the law requires.

The view that the dignity currently enjoyed by published rulings is excessive was noted by former Commissioner Caplin some years ago\footnote{267. Caplin, supra note 221 at 31-32.} when he alluded to the inadequacies of published rulings as "junior regulations," whose adoption lacked the protection of the procedures of the Administrative Procedure Act. He urged tying rulings more securely to fact situations, making them more like judicial opinions.\footnote{268. Id. at 32.} However, a judicial decision is both a judgment and an opinion. Now that a purpose of published rulings is to reveal the Service's thinking and is no longer limited to enabling the public to scrutinize the judgment to see if it reflects unwarranted favoritism, a mere recital of facts and a judgment as to the tax result would not be adequate.\footnote{269. Wright at 64. ("A bare statement of the material facts and the results reached is not enough.")} The opinion element in the ruling is important. However, when opinions emerge from a court they are the product of an adversary proceeding and often have the tentativeness of a lower court ruling. Published rulings, on the other hand, are adopted without public hearing and have nationwide affect immediately. Furthermore, the breadth of a judicial opinion is subjected to refinement through the process of distinguishing dictum from holding. Enforcement officials are not likely to be able to make this distinction with ease. Thus,
a ruling that there is sufficient continuity of interest if four twenty-five per cent shareholders receive one-half cash and one-half common stock, even if half of them receive all the cash, could be limited so that it would not apply if there is preferred stock or there are three shareholders owning fifty per cent of the stock who sell for cash. Similarly, a ruling that shareholder agreements create a second class of stock could be limited to non-family situations. In both cases, however, it is doubtful if such refinements would be pursued by enforcement officials.

The careful restriction of a published ruling to a specific fact situation is nonetheless useful in limiting the number of people who can, with any justification, claim a reliance interest if efforts are made to revoke it. However, in order to implement such a practice without making the ruling useless as a guide to the agency's thinking, the task of draftsmanship should be given to the Chief Counsel's office. A judicial opinion should be written by lawyers.

In the long run, however, the role of published rulings can only be de-emphasized by removing the image the public has of their current weight. The promise that they can generally be relied upon should be withdrawn. The public could be prepared for this step if more use were made of "substantive revenue procedures" which lay down guidelines for the issuance of private rulings. Although they indicate a legal position, the Service has not stated that they are binding. For example, the Service should be able to change its Revenue Procedures on contingent equity without difficulty. Like published rulings, they should be drafted in the Chief Counsel's office.

The role suggested for published rulings is not as unfamiliar as it

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270. See note 13 supra.
272. During 1966-68, the following substantive Revenue Procedures were published in the corporate area: Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232 (guidelines on (1) the "substantially all" requirement for C reorganizations; (2) continuity of interest in statutory mergers; (3) contingent stock (Rev. Proc. 67-13, 1967-1 CUM. BULL. 590 amplifies the contingent stock rules); (4) convertible preferred stock as "section 306 stock"; (5) plan of tax avoidance in distribution and disposition or redemption of section 306 stock); Rev. Proc. 67-14, 1967-1 CUM. BULL. 591 (conditions which must be present before IRS will consider issuance of a private ruling on a waiver of dividends transaction); Rev. Proc. 68-32, 1968-2 CUM. BULL. 918 (operating rules when ruling request involves stock attribution to and from a trust); Rev. Proc. 68-23, 1968-1 CUM. BULL. 821 (guidelines in § 367 transactions).

In the non-corporate area, the following were issued: Rev. Proc. 67-32, 1967-2 CUM. BULL. 659 (guidelines for reporting certain antitrust recoveries); Rev. Proc. 67-37, 1967-2 CUM. BULL. 668 (guidelines for exemption of farmers' cooperatives which sell non-producer items); Rev. Proc. 68-19, 1968-1 CUM. BULL. 810 (factors considered in taxing political contributions).

The Revenue Ruling which listed factors to determine the deductability of prepaid interest (see note 224 supra) would more appropriately have appeared as a Revenue Procedure.
sounds. We simply urge that their weight be closer to that currently afforded acquiescences. 273 Acquiescences bind Service employees 274 but are not “definitive statements of the Service’s interpretation of the law.” 275 They are retroactively revoked where published rulings would not be under current practice. 276 The Service apparently views them as expressing very tentative views on the application of legal rules to fact situations. 277 Published rulings should also play a similar role although the legal factors to be considered and how they are to be weighted would appear more explicitly in the “judicial opinion” drafted in the Chief Counsel’s office. Substantive Revenue Procedures would also play a similar tentative role, except that they would list factors not apply them to the facts.

The implications of these proposals for the public’s opportunity to rely on Service pronouncements should not be overemphasized. Their reduced weight would be felt in an agent’s increased willingness to distinguish a ruling both for and against a taxpayer, not in his authority to disregard a published position entirely. There would be a greater willingness in the national office to question the appropriateness of granting a private ruling based on a published position. Retroactive revocation would be more easily accomplished. 278

Private rulings, binding as before, would still be available. Their use would probably not increase since taxpayers who will seek insurance policies in the form of such rulings are likely to be equally nervous at present, 279 and there remain disincentives to apply for a ruling because of the heightened risk of audit. A useful by-product of shifting the authority for published rulings to the Chief Counsel’s office and of

274. Uretz, supra note 273 at 214; see 1968-2 CUM. BULL. 1.
275. Uretz, supra note 273 at 208.
276. Uretz, supra note 273 at 209-10. See, e.g., United States v. Cocke, 399 F.2d 433, 449-50 (5th Cir. 1968), cert. denied, 394 U.S. 922 (1968). On the other hand, the acquiescence in Minnesota Mortuaries, Inc. v. Commissioner, 4 T.C. 280 (1944), which appeared in 1945 CUM. BULL. 53, was revoked prospectively (1965-2 CUM. BULL. 7; Rev. Rul. 65-259, 1965-2 CUM. BULL. 174) where the acquiescence had been in effect for a long time and where it had “broad general application.”
277. Uretz, supra note 273 at 214. The Service would like to think that an acquiescence is easily limited to narrow fact situations but the prospective revocation of the acquiescence in Minnesota Mortuaries (see note 276 supra) indicates that is not always the case.
278. At present, the Service sometimes avoids a retroactive change of position even when the previous legal position has not been embodied in a statement which the Service considers to have the dignity of a published ruling; see, e.g., Rev. Proc. 68-40, 1968-2 CUM. BULL. 943 (suspends issuance of private rulings but continues prior administrative practice for transactions entered into before Sept. 26, 1968). See also note 275 supra concerning acquiescences.
279. Rogovin at 765, n.48.
establishing the tentativeness of all the Chief Counsel's opinions is
that private rulings issued by the Office of the Assistant Commissioner
(Technical) could be published without the fear that they would have a
binding effect. Since they need not be tampered with prior to publication,
their issuance to the public could serve its original function of revealing
the Service’s disposition of individual cases.

There is implicit in these suggestions a perception of the risks inher-.
ent in the published rulings program which is different from that
taken by the Service. As noted earlier, the Service’s reluctance to treat
its published positions as tentative is based on a desire not to appear
capricious. In two respects, however, this attitude seems outdated. First,
it developed at a time when tax administration was in its infancy and the
Service’s reputation was much less secure than it is today. At least since
the reorganization of the 1950’s,²⁸⁰ the Service’s efforts to administer the
law equitably have successfully reduced an earlier tarnished image of arbitrariness.²⁸¹ Second, the tax law can no longer be viewed as analogous
to penal laws whose administration is subject to special limits.²⁸² A tax
is not a penalty on one person; it is a burden shared by all to pay for
public expenditures. If it falls too lightly on some, either others must pay
or public needs must go unsatisfied.

The effort at improving rule-making to provide an administrative
alternative to Congressional action cannot stop at recognizing published
rulings to be merely tentative steps in the development toward formulat-
ing a rule. The regulatory process remains the most effective alternative
to legislation. The first step toward accepting an increased role for
Treasury Regulations is to recognize that the personnel and process
involved in their promulgation entitle them to play a role analogous
to that of the legislature in those areas of the tax law not clearly covered
by statute.²⁸³ Regulations are drafted in the Legislation and Regulations

²⁸¹. The effort to eliminate the “ounce of flesh” image has taken several forms. First, the practice of using a quota system which admonished enforcement officials to pro-
duce revenue, not to enforce the law, has been reversed. Memorandum to the Secretary of the Treasury, reprinted in, Hearings on Treasury-Post Office Appropriations for 1964 before the House Comm. on Appropriations, 88th Cong., 1st Sess. 378. Second, the Serv-
vice will attempt to avoid claims which appear to have only nuisance value. Thus, § 482 adjustments will be made if they are “significant,” not “minimal.” I.R.S. News Release, August 2, 1966, 667 CCH ¶ 6685 at 71,665.
²⁸². Survival of this attitude is most apparent when states try to enforce tax assess-
²⁸³. A description of the Regulations process appears in Rogovin at 758-63. A his-
tory and analysis of Treasury Regulations appears in Wright at 15-19, 26-34, 44-51.
Division of the Chief Counsel's office. Although they are signed by the Commissioner, they are approved by the Treasury which means that there is a further review in the Office of the Tax Legislative Counsel under the supervision of an Assistant Secretary of the Treasury. They are published only after public notice and hearing. Because Regulations are exposed to public comment made to policy oriented officials, they deserve a role far greater than they currently enjoy. Ironically, a number of arguments made to support the regulatory authority of the Treasury might prevent recognition of their essential legislative role. At an earlier time, when the rule-making power of administrative agencies seemed uncertain, emphasis was placed on "legislative" regulations which were entitled to the weight afforded statutes because of an express delegation of power from Congress. On the other hand, the inference developed that "interpretative" regulations were of inferior quality. Thus, the validity of interpretative regulations was supported with various crutches which might now serve to hold back their use. First, the length of time they are in effect has been considered relevant. However, the length of time an administrative interpretation has been followed is useful evidence in interpreting a statute even if it is not in the form of a regulation and does not, therefore, explain the added significance regulations enjoy. Second, the element of contemporaneity of the regulation with the passage of the statute is cited to support Treasury interpretations; however, to emphasize this factor would deny an on-going ex-

285. Treas. Reg. § 301.7805-1(a) (1960); WRIGHT at 27; Rogovin at 758.
286. Distinctions between legislative and interpretative regulations are not followed by the Treasury in deciding whether to use the procedures of the Administrative Procedure Act; Rogovin at 759, n.6; see Treas. Reg. § 601.601(a)(2) (1968).
287. We are not referring to the "Statement of Procedural Rules" which appears in the Code of Federal Regulations (26 C.F.R. pt. 601) (Supp. 1970), but is not published for comment prior to adoption. They are authorized by R.S. § 161, 5 U.S.C. § 33 (1958) (head of department authorized to prescribe regulations for conduct of department), not § 7805(a) (Treasury "shall prescribe all needful rules and regulations for the enforcement of this title").
288. Temporary Regulations, published without notice and hearing, are sometimes promulgated immediately after a new law is passed because there would be too great a delay until a better formed position has been developed. See, e.g., Rev. Proc. 70-5, I.R.B. 1970-8, 32, announcing the intent to issue such regulations pursuant to the Tax Reform Act.
289. WRIGHT at 16-17; Rogovin at 759; see also Griswold, A Summary of the Regulations Problem, 54 HARV. L. REV. 398, 401 (1941).
291. In Higgins v. Commissioner, 312 U.S. 212, 215-16 (1941), the Court suggested that the length of time an interpretation has been followed is less significant when the published interpretation is not a regulation.
pansive role for the Treasury to develop the law as problems arise over the years. Finally, the doctrine of reenactment is now a weak reed on which to support the validity of a regulation since tax laws are no longer periodically renewed. Emphasis on these points was perhaps suitable before the Treasury made use of the Administrative Procedure Act's notice and hearing provisions, especially since the Treasury did not follow a practice of publishing its regulations for public comment before the Administrative Procedure Act was adopted. However, now that the procedures for issuing regulations have been assimilated into the legislative process, and the agency's power to proscribe rules is more secure, drawing sharp lines between different types of regulations can only impede a greater rule-making role for the Treasury.

Indeed, the distinction between legislative and administrative regulations has little foundation in current tax law. Legislative regulations have been invalidated. Furthermore, the statutory basis for such a sharp distinction is uncertain. Language similar to the general authorization for regulations in section 7805(a) has been recently held to authorize an agency to create binding obligations. While the fact that Congress has explicitly thrown up its hands in despair and asked for help can be a relevant factor in determining a regulation's validity, the label of "legisla-

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293. See, e.g., Russell Mfg. Co. v. United States, 175 F. Supp. 159, 162, n.1 (Ct. Cl. 1959), in which lack of contemporaneousness was a factor in the court's refusal to follow a regulation.

294. WRIGHT at 29-31.

295. 60 Stat. 237 (1946). Most of the leading articles on the regulatory process in the tax field were published in the early 1940's before the passage of the Administrative Procedure Act; see Griswold, supra note 287 at n.1. There was, however, a suggestion to increase the role of Treasury Regulations prior to the passage of the Administrative Procedure Act; Eisenstein, Some Iconoclastic Reflections on Tax Administration, 58 HARV. L. REV. 477, 505-47 (1945).

296. ADMINISTRATIVE PROCEDURE IN GOVERNMENT AGENCIES, MONOGRAPH OF THE ATTORNEY GENERAL'S COMMITTEE ON ADMINISTRATIVE PROCEDURE (pt. 9); ADMINISTRATION OF THE INTERNAL REVENUE LAWS, S. Doc. No. 10, 77th Cong., 1st Sess. 64 (1941).

297. The analogy is no less appropriate because the power of retroactive revocation might be limited; See Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939). The Treasury's lack of elected status justifies greater limits on the exercise of such power. See Unterman v. Anderson, 276 U.S. 440 (1928), where a limit was placed on legislative retroactivity, although the result was questionable in that case.

298. See, e.g., Willett v. Commissioner, 365 F.2d 760 (5th Cir. 1966).

299. See Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268, 277 (1969), in which the Court upheld agency rules pursuant to 42 U.S.C. § 1408 (1964 ed., Supp. III) which states that "under § 8 of the United States Housing Act of 1937, . . . HUD [may] from time to time make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this Act."

See also Worrell v. Sterrett, CCH Pov. LAW REP. ¶ 10575 at 11,461, No. 69 R. 33 (N.D. Ind. Oct. 15, 1969), holding that 42 U.S.C.A. § 1302 authorized "legislative regulations" ("The Secretary . . . shall make and publish such rules and regulations . . . as may be necessary to the efficient administration of [his] functions . . ."); Lewis v. Martin, 90 S. Ct. 1282 (1970).
tive regulation” suggests a dignity which denigrates the authority of “interpretative” regulations and helps to deprive them of the role they should play in developing the tax law.

There are a number of risks in expanding the use of Regulations. First, there is the danger that lobbying pressure will simply shift from Congress to the Treasury, which would be especially serious if the new manpower needs created by expanding the use of Regulations are not met by providing the Treasury with enough capable and experienced personnel to handle the work. Second, premature mummification of the law through Regulations is undesirable. Some period during which tentative positions are applied is useful in educating the rule-maker to the nuances of the law’s application. The need for certainty in the tax law can be met through the private rulings program without stultifying the rule-making process. However, there is no reason why the Treasury cannot develop regulations in an area of the law which is sufficiently aged. Evidence of the Treasury’s willingness to perform this role appeared in the recent Regulations to section 305, and the effort met with Congressional approval.

There is a decided possibility that these suggestions merely tinker ineffectually with a process immune to reform. A more comprehensive study is needed of the actual operation of acquiescences, private rulings, published rulings, substantive revenue procedures and regulations in areas other than corporate acquisitions to determine the contributions each makes to coherent or confused development of the law and the relationship of such developments to tax legislation. Enough data

300. See Shapiro, supra note 219 at 959, 961.
302. Petitions from the public regarding regulations, authorized by 5 U.S.C.A. 555(e), could play a role in identifying areas where rule-making is needed.
305. For example, if ambitious Regulations lead to detailed Congressional responses, Regulations might not resort to legislation. See, e.g., §§ 671-78 for the Congressional response to the Clifford and Mallinckrodt regulations, and see note 231 supra for the Congressional response to Treasury regulations on industrial revenue bonds.
seems available, however, to suggest that a combination of public opinion forcing closer scrutiny of the legislative process and the Treasury taking a bolder role in finding and developing the open spaces in the statute could lead to a reversal of the current pattern of elaborate statutory detail, confused judicial and administrative interpretation, and ill-considered tax subsidies.