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September 24, 1992

FILE NO. 92-017

BUSINESS ORGANIZATIONS:
Calculation of Paid-In Capital
Following Vertical Merger of Corporations

Honorable George H. Ryan
Secretary of State
State House, Room 213
Springfield, Illinois 62756

Dear Secretary Ryan:

I have your letter wherein you inquire regarding the proper method for calculating the paid-in capital of a surviving corporation following a vertical merger, for purposes of assessing the franchise tax to be paid by that corporation. For the reasons hereinafter stated, it is my opinion that the surviving corporation following a vertical merger may report paid-in capital totalling less than the sum of the paid-in capital of the merging corporations if the revised total is consistent with the economic realities of the merger and with generally-accepted accounting principles.

You have stated that the Department of Business Services has traditionally calculated the paid-in capital of the

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corporation surviving a merger as the sum of the paid-in capital of each of the merging corporations. This method is satisfactory when neither of the merging corporations owns shares of the other (a "horizontal merger"). However, it is argued that when a parent and a subsidiary corporation merge (a "vertical merger"), the aggregation of the paid-in capital of the merging corporations ignores economic reality, as well as generally-accepted principles of accounting. See, e.g., Financial Accounting Standards Board Technical Bulletin 85-5 and American Institute of Certified Public Accountants Interpretations 26 and 39 of Accounting Principles Board Opinion 16.

Prior to a merger, the parent corporation holds the stock of the subsidiary corporation as an asset. In an "upstream merger" (subsidiary into parent), the parent corporation essentially exchanges the subsidiary's stock for the assets and liabilities of the subsidiary. Thus, the value that had been represented by the paid-in capital of the subsidiary becomes assets and liabilities, rather than capital, of the surviving corporation. The shareholders of that corporation have added nothing to its capital. In a "downstream merger" (parent into subsidiary), the stock of the subsidiary is generally distributed to the shareholders of the parent in exchange for the stock of the parent, which is then cancelled. The value which had been represented by the paid-in capital of the parent becomes assets and liabilities of the surviving corporation, and the issued stock represents only that paid-in capital which had been allocated to the former subsidiary. In either an upstream or a downstream merger, the surviving corporation no longer owns any of the subsidiary's stock.

"Paid-in capital" is defined by subsection 1.80(j) of the Business Corporation Act of 1983 (Ill. Rev. Stat. 1991, ch. 32, par. 1.80) as follows:

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> (j) 'Paid-in capital' means the sum of the cash and other consideration received, less expenses, including commissions, paid or incurred by the corporation, in connection with the issuance of shares, plus any cash and other consideration contributed to the corporation by or on behalf of its shareholders, plus amounts added or transferred to paid-in capital by action of the board of directors or shareholders pursuant to a share dividend, share split, or otherwise, minus reductions from that sum effected by an acquisition of its own shares, to the extent of the cost of the reacquired shares or a lesser amount as may be elected by the corporation. Irrespective of the manner of designation thereof by the laws under which a foreign corporation is or may be organized, paid-in capital of a foreign corporation shall be determined on the same basis and in the same manner as paid-in capital of a domestic corporation, for the purpose of computing license fees, franchise taxes and other charges imposed by this Act.
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> * * * "

Section 14.25 of the Business Corporation Act of 1983 (Ill. Rev. Stat. 1991, ch. 32, par. 14.25) provides, in part:

> "Report following merger or cancellation of shares/reduction in paid-in capital. (a) Each domestic corporation and each foreign corporation authorized to transact business in this State

> that is a party to a statutory merger and is the surviving corporation, or that effects the cancellation of its shares, or that effects a reduction in its paid-in capital in connection with the cancellation of its shares, as permitted by this Act, and does not report that event to the Secretary of State by any other report required by this Act to be filed; and each domestic corporation that is the new corporation in a consolidation, shall execute and file, in accordance with Section 1.10 of this Act, a report setting forth:
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> (6) A statement, expressed in dollars, of the amount of paid-in capital of the corporation after giving effect to the change.
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> (d) Until the report shall have been filed in the office of the Secretary of State, the basis of the annual franchise tax payable by the corporation shall not be reduced * * *."

Section 15.40 of the Business Corporation Act of 1983 (Ill. Rev. Stat. 1991, ch. 32, par. 15.40) provides in part:

> "Basis for computation of franchise taxes payable by domestic corporations. The basis for the initial franchise tax payable by a domestic corporation shall be the amount represented in this State, determined in accordance with the provisions of this Section, of its paid-in capital as disclosed by its first report of the issuance of shares.
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> In case of a statutory merger or consolidation of domestic corporations, the basis for an additional franchise tax payable by the surviving or new corporation shall be the increased amount represented in this State, determined in accordance with the provisions of this Section, of the paid-in capital of the surviving or new corporation immediately

> after the merger or consolidation over the aggregate of the amounts represented in this State of the paid-in capital of the merged or consolidated corporations disclosed by the latest reports filed by those corporations, respectively, with the Secretary of State as required by this Act * * *.
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> The basis for the annual franchise tax payable by a domestic corporation shall be the amount represented in this State, determined in accordance with the provisions of this Section, of its paid-in capital on the last day of the third month preceding the anniversary month or, in the case of a corporation that has established an extended filing month, on the last day of the corporation's fiscal year preceding the extended filing month.
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> * * * "

The language in section 1.80 of the Act relating to reduction of paid-in capital upon the corporation's acquisition of its own shares, the language in section 14.25 of the Act relating to mergers, and subsection 14.25(d) were added to the Act by Public Act 84-1412, effective January 1, 1987. Public Act 84-1412 repealed former section 9.15 of the Business Corporation Act, which had specifically provided for reductions of paid-in capital in certain instances. Prior to the repeal of section 9.15, its provisions could be used in a carefully structured vertical merger to avoid the aggregation of paid-in capital and to achieve the result now being advocated. Neither the legislative history nor the combined effect of the amendatory provisions of Public Act 84-1412 shows a clear legislative intent either to prohibit or to permit reductions of paid-in capital following a vertical merger.

In Majestic Household Utilities Corp. v. Stratton (1933), 353 Ill. 86, the plaintiff corporation had transferred all of its assets to another corporation in exchange for shares of the transferee corporation. Most of the shares of Majestic had been surrendered in exchange for shares of the transferee, and the Majestic shares were cancelled and retired. The General Corporation Act of 1919 provided for the filing of a certificate whenever stock was issued, but made no provision for the filing of a certificate of stock reduction. Majestic reported the cancellation and retirement of its stock in its annual report, but took no steps to reduce its capital stock by way of charter amendment, dissolution, merger or consolidation. Because there was no specific statutory language permitting the capital reduction, the Secretary assessed the franchise tax based upon the maximum number of shares issued, rather than the relatively small number still outstanding. The Illinois Supreme Court ruled in favor of Majestic, holding that the Secretary's position was untenable in view of statutory provisions specifically authorizing corporations to exchange or sell all of their assets. Under the circumstances, no charter amendment was required. The court further stated:

> " * * *
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> When certificates of stock are officially executed and delivered by the corporation to its stockholders they are issued, in the ordinary sense. However, when such stock is called in and canceled of record in ex-

> change for stock of another corporation the original shares of stock can no longer be said to be issued. They are then permanently retired and removed from issue. Whatever doubt or uncertainty there might be in this regard, it is a fundamental rule of statutory construction that taxing statutes must be construed strictly. (People v. Chicago and Eastern Illinois Railway Co. 314 Ill. 596.) In interpreting statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen. (Gould v. Gould, 245 U.S. 151; Bowers v. New York and Albany Lighterage Co. 273 id. 346.) Stock once issued and afterwards surrendered and canceled by the issuing corporation may be said to be removed from issue when it has been permanently withdrawn from circulation with no duplicate or substitute available for re-issue. * * * [I]t was the duty of defendant to fix and assess its franchise tax upon the number of issued shares then in existence and the amount received therefor. * * *
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> Majestic Household Utilities Corp. v. Stratton (1933), 353 Ill. 86, 93-94.

Relying upon the above-quoted language, Attorney General Castle subsequently advised the Secretary of State that a railroad corporation should be permitted to file an amended annual report indicating the redemption of cumulative preferred stock, resulting in a stated capital and paid-in surplus reduction of approximately $30,000,000. (1955 Ill. Att'y Gen. Op. 130.) There were no specific statutory provisions pertaining to the redemption and cancellation of shares of a railroad corporation. Attorney General Castle concluded, however, that the 1933 Act should be broadly interpreted to permit the amended or supplemental report to show the redemption and cancellation of shares.

There is no provision of the Business Corporation Act which requires that the paid-in capital of the survivor of a vertical merger be calculated by aggregating the paid-in capital of the parent and subsidiary prior to merger. Section 15.40 of the Act merely provides for franchise taxation of the increase in paid-in capital, if any, allocated to Illinois as a result of the merger. Sections 9.05 and 14.25 both authorize paid-in capital reductions from the reacquisition and cancellation of shares, but neither section expressly states that this is to be the sole and exclusive means of reducing paid-in capital. Further, subsections 14.25(a)(6) and (d) of the Act imply that mergers may reduce paid-in capital.

Based upon the reasoning of Majestic Household Utilities Corp. v. Stratton and Attorney General Castle's opinion, it is my opinion that section 14.25 of the Business Corporation Act should be broadly construed to permit the surviving corporation in a vertical merger to report a reduction in paid-in capital based upon the economic realities of the merger and generally-accepted accounting principles. To conclude to the contrary would ignore the fact that in a vertical merger, no additional capital is actually paid into the corporation by or on behalf of the shareholders, no new shareholders are added and no new shares are issued. The two pre-merger corporations have paid franchise taxes upon essentially the same capital for the privilege of doing business as separate entities. Once their merger has occurred, there is no longer any basis for the double taxation of that capital.

Respectfully yours,

ROLAND W. BURRIS
ATTORNEY GENERAL