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FEDERAL TAX POLICY AND THE MARKET FOR CORPORATE CONTROL: RELATIONSHIPS AND CONSEQUENCES

Robert P. Strauss

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ECONOMIC DARWINISM AND CORPORATE CONTROL

A fundamental premise of a market economy is that competition enhances the overall efficiency in that economy, generates economic growth, and expands the number of job opportunities and income available to all market participants. Since the mid-nineteenth century, the corporate form in the United States has been the principal vehicle through which large-scale capital investments have been made to exploit new, capital-intensive technologies in manufacturing and, among other things, to create a transportation network that has allowed the exploitation of natural resources and agricultural products. In Ohio and Pennsylvania, the growth in primary metals, rail transportation, and energy could not have occurred without the corporate form to raise and expend the necessary capital, which in turn led to the growth in the cities and a long-term increase in the country's general standard of living.

The public corporation is a creature of the state in which it is incorporated pursuant to state statutes governing the right to incorporate. Through the corporate form, shareholders delegate significant discretion and latitude to management to organize the internal affairs of the business, and to market the goods and services such businesses create. The corporate form provides a number of distinct benefits to shareholders: perpetuity of the corporation from generation to generation, a separate identity that results in limited liability for shareholders and management so that they are not directly liable for each of the actions of the corporation itself, and easy transfer of share ownership.

A consequence of the public trading of shares in public corporations is that stockholders may readily alter their investments based on their analysis and expectations of the relative profitability of each business that competes for shareholder capital. The ultimate reward for each shareholder investing in a corporation is the periodic receipt,of dividends paid by the corporation along with any increase in share value that represents expected increases in the future income stream of the company.

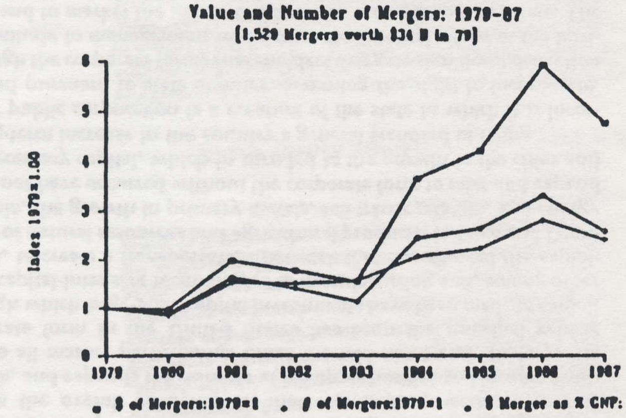
Over the business cycle, the prospects and profitability of any firm will vary, and its stock price will accordingly reflect such fortunes; in turn, shareholders will be positively or adversely affected as their wealth holdings in various businesses change with market-share prices. For any number of ordinary business reasons, a particular company or person will expand or contract its business as it adjusts to changes in market tastes for its goods and services, the presence of competitors in the market in which such goods and services sell, its own cost circumstances (labor, capital, and materials), and changes in technology. Economic efficiency is served when such business activities occur at arms-length prices, and when business assets are redeployed to their most profitable use.

This process of economic change, which necessarily involves the purchase and sale of assets owned by businesses, or of the businesses themselves, is generally healthy; and it may be viewed as an organic part of the economic process. However, this impersonal description of the Darwinian process of economic competition understates the drama, if not the trauma, that a change in business ownership can create for current employees, their families, and their communities. In the abstract it would seem generally beneficial to allow the just described process to work itself out, but when it involves a major employer and prospects of plant closings and permanent layoffs, this theoretical justification for competition becomes less acceptable, and the circumstances of changes in corporate ownership become a matter of public policy.

Public Concerns: The Level of Acquisition Activity and Its Motivation

The issue of the desirability of changes in ownership and control has become increasingly pronounced as the pace of merger-and-acquisition activity has increased in the 1980s. In 1987, better than $167.5 billion of corporate assets changed ownership as a result of mergers, acquisitions, and leveraged buyouts (LBOs).[1] By contrast, in 1979, mergers, acquisi-

Figure 10.1
Merger and Acquisition Activity, 1979–1987



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tions, and leveraged buyouts amounted to only $34.2 billion. Equally troubling to some is the fact that foreign participation has increased dramatically over this nine-year period as well: In 1986, 12 percent of the transactions, measured by value, were made by non-U.S.-firms acquiring U.S. firms; while in 1987, 25 percent of the transactions were made by non-U.S. firms acquiring U.S. firms.[2]

Figure 10.1 displays recent mergers and acquisitions from 1979 through 1987. Using 1979 as the base year, we see that merger activity increased fivefold in that nine-year period; GNP by contrast did not quite double. In 1986, the peak year for merger-and-acquisition activity, better than $204 billion in assets changed hands, or 4.6% of GNP. Scherer (1970) observed three earlier merger-and-acquisition waves in the U.S. industrial economy: 1887–1904, 1916–1929, and 1948–1970; it is evident that we are experiencing a fourth wave of merger activity in the mid-1980s.

Elsewhere in this volume experts discuss the social desirability of such widespread changes in corporate ownership and control. Whether shareholder and societal wealth are enhanced by such transactions is also an important matter. Here I shall concentrate on the more technical but nonetheless important question of whether such merger-and-acquisition

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activity artificially results from provisions in our federal tax laws. In particular I shall examine the question of whether the Internal Revenue Code unwittingly (and wittingly) provides incentives for such changes in corporate ownership and control by encouraging profitable firms to take over unprofitable firms in order to acquire the favorable tax attributes of the target corporation.

The answer to this apparently simple question involves examining some of the most complex parts of the U.S. tax system. Moreover, the answer to the question has changed with the Tax Reform Act of 1986, which sought to substantially reduce, if not eliminate, what had become "trafficking" in corporate tax losses and unused tax credits, and sought to limit a number of indirect takeover strategies. For example, it is often conjectured that some takeover attempts are motivated by the excess assets of the target's qualified pension plan. In this circumstance, either the target firm or the buyer will seek to use the excess assets to finance the acquisition or to buy back shares from the market or from the buyer (so-called greenmail). The complex manner in which the Internal Revenue Code encourages such activities and recent actions by the Congress to limit such incentives are important aspects to consider.

My purpose here is thus severalfold:

1. To provide a background on how corporations and their pension funds are generally organized and affected by the Internal Revenue Code;
2. To discuss the historical tax-planning methods by which corporations have been able to lessen their tax burden and that of their shareholders, with particular attention to the importance of the *General Utilities* Doctrine;
3. To discuss the mechanics of mergers and acquisitions as they are affected by the federal Internal Revenue Code;
4. To underscore how net operating loss, unused investment tax and foreign tax credits, the deductibility of interest costs, and the tax-exempt nature of qualified pension plans affect the attractiveness of the target company; and,
5. To appraise the various tax incentives and tax considerations for mergers and acquisitions as they exist post-Tax Reform Act of 1986.

The reader should be forewarned that some of this discussion is complex; it is my hope that some numerical examples will simplify and help explain the importance of various federal tax considerations as they impact on the merger and acquisition process.

KEY PROVISIONS OF THE INTERNAL REVENUE CODE AFFECTING THE MERGER-AND-ACQUISITION DECISION

The effect of the Internal Revenue Code on the acquisition-and-merger decision can be analyzed directly in terms of:

1. The federal corporate income tax; and
2. The federal individual income tax.[3]

Also, the federal tax treatment of certain pension plans creates several indirect incentives for merger and acquisition. The general structure of these direct effects is discussed below, along with the important matter of liquidations.

The Federal Corporate and Individual Income Taxes: Two Tiers and Double Taxation

Historically, income earned by a corporation has been taxed at a rate approximating 46 percent and, since World War II, after-tax income paid to shareholders in the form of dividends has been taxed at a tax rate as high as 70 percent. This system of taxation of corporate source income plus taxation of distributions at the individual level has been criticized as constituting double taxation and imposing a much higher tax than had the shareholder earned the income directly.[4]

An example makes this textbook argument clear: Assume that the corporation has pre-tax profits of $100 and faces a corporate tax rate of 46 percent; further, assume that the shareholder is in the 50-percent tax bracket for earned and unearned income. Now let us compare the overall taxation of $100 of corporate source income to $100 of wage (or sole proprietorship) income. Were the shareholder to be taxed on $100 of wage income at a marginal tax rate of 50 percent, then $50 of total taxes would be due. On the other hand, if we begin with $100 of corporate source income which is taxed first at the corporate level ($46 of tax with a tax rate of 46 percent), and then at the shareholder level on the presumed $54 of dividends, we arrive at a total tax burden of $73 ($46 of corporate tax plus $27 of personal tax). Thus, the two tier taxation of corporate source income gives rise to a tax differential of 23 percentage points.[5]

For a considerable period of time, the tax rate on dividend income was above that for wage income, for example, 70 percent versus 50 percent, so the above example was even more extreme. Clearly, unless shareholders had a peculiar willingness to finance the costs of government through voluntarily higher taxes, they had a clear incentive to find ways to work with the corporation to move toward Case 2 and away from the tax consequences of Case 1 (see Table 10.1). To the extent that shareholders could forgo current dividends, and to the extent that the corporation used its after-tax income for reinvestments in itself, the stock market simply capitalized the forgone dividends, and shareholders looked for periods when their own tax circumstances favored selling the appreciated stock and realizing the forgone income.

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Table 10.1
The Extra Burden of Corporate and Individual Income Taxes

Case 1: $100 of Corporate Income			Case 2: $100 of Personal Income
Corporate Income	$100		
Corporate Tax	-46	46	
After Tax Income	$54		
Dividends Recvd	54		$100
Personal Tax	-27	27	-50
After Tax Income	$27		$50
Total Tax		$73	$50
Effective Tax Rate		.73	.50

Tax Treatment of Long-Term Capital Gains

The next important structural feature of the U.S. federal tax system that needs to be understood in conjunction with the merger-and-acquisition decision involves the historically preferential tax treatment accorded to capital gains on assets held more than one year. Technically, the difference between the net sales price of the stock and the original cost or "basis" in the stock historically constituted a capital gain, as contrasted to ordinary income of individuals and corporations. The preferential treatment has been accorded by excluding part of the gain from tax so that the application of the taxpayer's marginal tax rate would result in a lower effective tax rate. For example, up until 1986, individuals had been able to exclude as much as 60 percent of long-term gain from tax, resulting in a maximum effective rate of 20 percent on long-term capital gains.[6]

With such preferential tax treatment of capital gains compared to ordinary income, our taxpayer and corporation have an incentive to not only forgo payment of dividends to the individual shareholder, but in general to structure transactions at the corporate and individual level so that the ordinary income is viewed as long-term capital gains by the tax system. Not only is 20 percent a considerably lower tax rate than 50 percent, by carefully timing the date of realization and receiving the proceeds of the sale over time as an installment sale, the shareholder could easily be in a tax bracket well below 20 percent. It should also be noted that if the shares are not disposed of prior to death but rather are transmitted through an estate to the next generation, the basis of the shares will be "stepped-up" to market value without any tax consequence to either the estate or the beneficiary. As a consequence, the next generation could then dispose of the shares at market value with no personal tax whatsoever. If there were appreciation after receiving the bequest, the tax would only be on that portion of the appreciation that was at capital gains tax rates.

The *General Utilities* Doctrine

Between 1935 and 1986, as a result of a U.S. Supreme Court decision and subsequent ratification by the Congress in Sections 311, 336, and 337 of the Internal Revenue Code, the impact of the above-mentioned two-tiered structure of the corporate and individual income tax (Case 1) was substantially mitigated in certain important circumstances.[7] Under the *General Utilities* rule, the distribution by a corporation of certain appreciated property to shareholders on the liquidation of the appreciated property resulted in non-recognition (for corporate tax purposes) of the gain at the corporate level, and tax at only capital gains rates at the shareholder level. The history of the *General Utilities* case underlines the importance of this mechanism.

In 1927, General Utilities purchased 50 percent of the shares of Island Edison Company for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' holdings in Island Edison, which apparently had a fair market value of more than $1 million. If General Utilities had sold the shares directly it would have been forced to pay significant corporate tax on the difference between $1 million and $2,000. Instead, General Utilities offered to distribute the Island Edison stock to its shareholders with the understanding that the shareholders would in turn sell their stock to the prospective buyer. However, the shareholders were under no obligation to sell the shares under the terms of the distribution.

General Utilities declared a dividend in an amount equal to the value of the Island Edison stock to be payable in shares of that stock. General Utilities distributed the Island Edison shares, and four days later the shareholders sold the Island Edison shares to the buyer on the terms previously negotiated by the General Utilities officers. The IRS held that the distribution of the Island Edison shares in the amount of $1 million was a taxable transaction to General Utilities. The Supreme Court held that the distribution was not taxable income at the corporate level. Thus, the shareholders in the General Utilities case simply paid long-term capital gains taxes on the differences between the $2,000 purchase price that the corporation made on their behalf and the $1 million that the shareholders realized upon sale of their shares.[8] In a number of subsequent related cases, the Court generally upheld its original decision with the general effect that from 1935 through 1985, no gain at the corporate level (and thus no corporate tax) was realized on corporate distributions of appreciated property to shareholders.

In 1954, Congress enacted Section 311(a) of the Internal Revenue Code, which essentially provided that a corporation recognized no gain or loss on a non-liquidating distribution of property with respect to its stock. Section 336 was also enacted to provide for non-recognition of gain or loss to a corporation on distributions of property in partial or complete liquidations. Also, in the 1954 Act, Section 337 of the code stated that if a corporation adopted a plan of complete liquidation and distributed all its assets to its shareholders within 12 months, there were no corporate-level tax consequences of the gain or loss on the sale of such property.

In effect, the *General Utilities* Doctrine, which became codified and refined over the period of 1935 through 1986, provided a method of relieving the double taxation of corporate source income described above. Equally beneficial, of course, is the fact that such a transformation of corporate source income to the shareholder level was taxed during this period at long-term capital gains rates rather than as ordinary income; for example, compare a tax rate of 73 percent in Case 1 with a tax rate of 20 percent, which is the maximum tax rate on long-term capital gains realized by individuals in the 1980s.

In effect, the *General Utilities* Doctrine created a vehicle for individuals to utilize the corporate form to acquire assets, hold them until they appreciated, shield them from personal risk during the appreciation period, and then turn over effective ownership at the shareholder level for disposition at long-term capital gains tax rates. As such, it created an incentive for corporations to acquire other corporations and then liquidate them in a specific fashion. Alternatively, it created the incentive for a corporation to form an entity within the corporation that could be spun off for shareholders to sell at long-term capital gains rates.[9]

Federal Tax Implications of Debt versus Equity Financing

As noted earlier, dividend payments are paid out of after-tax income. On the other hand, interest payments to bondholders are paid out of before-tax income, and are an ordinary cost of doing business. Since both equity and debt are sources of capital to the firm, the ability to deduct the cost of debt capital as contrasted to the inability of deducting

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Table 10.2
Effect of Debt Financing on Yield to Shareholder

Item	All Equity Firm	50% Debt Financed Firm
Balance Sheet		
Total assets	$1,000	$1,000
Debt	0	500
Shareholders Equity	1,000	500
Income Statement		
Operating Income	200	200
Interest Expense	0	70
Taxable Income	200	130
Corporate Tax (46%)	92	59.80
After-Tax Income	$108	$70.20
Return on Equity :		
Income/Equity	10.8%	14.04%

the cost of equity capital provides a powerful incentive to favor debt financing. An example will make this more clear.[10]

Consider two corporations each with $1,000 of total assets and each experiencing $200 operating income; Corporation A is an all-equity corporation while Corporation B is financed half by equity and half by debt. Let us assume that the debt was borrowed at 14 percent, and that the corporate tax rate is 46 percent. The question we wish to answer is how shareholders of each firm fare in terms of the after-tax return on their equity.

Table 10.2 lays out the analysis. The all-equity firm has no interest expenses to deduct, pays $92 on its $200 of operating income, and provides an after-tax return to its shareholders of 10.8 percent ($108 of after-tax income divided by $1,000 of shareholder equity). The half-equity, half-debt financed firm, by contrast, has only $130 of taxable income by virtue of paying $70 of interest expenses, and pays $59.80 in taxes. Its after-tax return is 14.04 percent ($70.20 of after-tax income divided by $500 of shareholder equity). Thus, the leveraged (or indebted) firm provides a rate of return to shareholders that is 40 percent greater than the return of the firm that relies on just equity for its capital. To the extent that a firm eschews debt to raise additional capital, it may be short-changing its shareholders.

Alternatively, one may view firms that are not leveraged as targets for takeover, since a change in the composition of the target's balance sheet can immediately benefit the remaining shareholders. A leveraged buyout (LBO) is really an acquisition of an economically profitable, "under-leveraged" firm by another firm that is willing to buy it on a highly leveraged basis. For example, it has historically been common practice for a buyer to contribute 20 percent of the purchase price as equity and borrow the remaining 80 percent through the issuance of short-term bonds reflecting the high degree of risk; these so-called junk bonds are secured, at best, by pledges of the target's future profits, and typically pay high rates of interest. Typically such bonds are unsecured, and accordingly pay very high rates of interest to reflect the high level of risk. The increased interest payments of the new firm are paid for by the increased cash flow to the target that results from the interest deductions that reduce taxable income.

Some Implications of Corporate Losses and Unutilized Tax Credits

When a business' costs exceed its receipts, we characterize the business as "losing money," and, if this circumstance persists over any appreciable period of time, we would not view the firm as being particularly attractive for investment or acquisition purposes. However, the commonsense characterization of the economic position of the firm is often quite distant from the realities of corporate tax and financial reporting, and the firm indeed may be quite healthy at least from a financial reporting perspective. In turn, it may be an attractive takeover target.

In order to appreciate how this may come about, it is important first to understand how a corporate loss can be generated for tax-reporting purposes while profits may be reported for financial-reporting purposes. Second, we must understand how such federal tax attributes persist over time, and how they create incentives for acquisitions.

Generating Federal Tax Loses

Two types of disparities between tax-accounting and financial-accounting rules can generate tax losses: general differences between these rules, and specific provisions of the Internal Revenue Code that provide special considerations to particular industries. By far the most important general difference between the two rules involves the measurement of depreciation. In the abstract, it is appropriate for a business to deduct as a cost of doing business the loss in value of machinery and equipment that results from their usage. Space limitations prevent a historical description of how our tax-depreciation rules have evolved; however, the more generous depreciation allowances accorded under the Economic Recovery Act highlight how disparate tax- and financial-accounting rules can become. Prior to 1981, taxpayers were depreciating apartment buildings on average over 32 years, while bank buildings were depreciated over 43 years. As a result of the Economic Recovery Act of 1981, useful lives were dramatically shortened. In the case of real property such as apartment buildings, the tax life was shortened to 16 years. For financial-reporting purposes the longer time period has generally remained in effect.

Essentially, cutting in half the time period across which one may deduct the value of the asset means that the present value of the deductions will increase geometrically since all deductions are increasing much earlier than before. In turn, such earlier deductions reduce gross receipts and taxable income, and in a wide array of circumstances create expenses in excess of receipts for tax-reporting purposes, for example, losses for tax purposes as contrasted to profits reported using the depreciation rules required for financial-reporting purposes.[11]

The matter of generous depreciation deductions creating artificial tax losses becomes more important in acquisitions that are debt-financed, since the base for calculating depreciation depends on the purchase price. If the buyer pays a very high price for the target firm, it will enjoy very large depreciation deductions at the outset. Using debt financing with balloon forms of debt, the buyer can further increase the apparent excess of costs over revenues, which will create a shielding from taxation cash flow generated from other activities.

Beyond this general difference in tax- and financial-reporting rules, there have historically been a large number of specific provisions of the Internal Revenue Code that accord particular businesses cost deductions that are larger than allowed under financial-reporting rules. For example, commercial banks have been historically allowed to deduct as bad debt reserves a percentage (.6 percent) of certain loans without regard to actual bad-debt experience. As a result, banks have historically paid little federal corporate income tax.

Historically, firms that constructed long-lived assets over a period of time, for example, manufacturers of commercial aircraft, have been able to forestall recognizing the income received from the sale of such aircraft until the entire fleet of assets (aircraft) constructed for a customer has been delivered, but have been able to recognize the costs of construction of each component delivered on essentially a current basis. Under financial-accounting rules, this completed-contract method of accounting is not permitted, and the costs and income of each element of a long-term contract must be simultaneously recognized. Again, this sort of difference between tax-accounting and financial-accounting rules can lead to a firm reporting tax losses to the Internal Revenue Service while reporting profits and paying dividends to shareholders. With such a significant divergence in the way costs are measured between the tax system and financial reporting standards, it follows that a firm can report a net operating loss (NOL) for tax purposes while still paying dividends and issuing healthy financial reports to shareholders.

The Value of Corporate Tax Attributes over Time

It is generally agreed that 12 months is an arbitrary period over which to record income and impose taxes. As a consequence, the Internal Revenue Code has allowed corporate taxpayers to carry forward losses created in one year to subsequent years to offset future income and thereby lower future taxes. Also, carrybacks of such losses to prior, profitable years' returns have been allowed. With carrybacks, firms recompute their taxes and obtain a refund check from the IRS. Such forward and backward averaging has been accorded in recognition of the arbitrary nature of the 12-month taxable year. In addition to the ability to carry forward and carry back tax losses, firms have similarly been able to carry forward and carry back tax credits earned from making certain investments in equipment that they are currently not able to use.

To the extent that a firm has such tax losses or tax credits on its books, they represent an opportunity for firms with positive taxes, through careful merger, to reduce their joint taxes upon combination. Firms with unused NOLs may find themselves unable to use them within a few years, while other, profitable and taxable firms may be able to use them immediately.[12] For example, if firm A is in the 46 percent-marginal tax bracket, and another firm, B, has losses, firm B's tax losses are of value to firm A since it can reduce its tax liabilities and increase its cash flow, holding all else constant. Firm A should be willing to pay up to the value of the tax shield that would result to it were the losses applied to reduce its tax liabilities, for example, $.46 for each $1.00 of loss firm B has on its books.

It is argued by some (see especially Gilson, Scholes, and Wolfson, 1988), that the price of A's shares in the stock market should perfectly reflect the capitalization of this tax attribute. This presumes that the stock market is perfectly informed about A's tax return. In fact, Section 6103 of the Internal Revenue Code makes it a criminal offense for anyone in the IRS to disclose such tax-return information, so it is unlikely that the stock market would be perfectly informed. On the other hand, when firms look for suitors, they will voluntarily disclose such information to help market the business.

It should also be noted that the entity represented on a firm's filings to the Security and Exchange Commission under Regulation 10-k is often rather different than the entity reported to the Internal Revenue Service. Not only does the 10-k utilize financial- as contrasted with tax-accounting methods, in addition, the entity reported to the SEC is the worldwide entity, and includes subsidiaries of which 50 percent or more are owned.

By contrast, the entity for U.S. tax purposes is the domestic portion of a multinational corporation, which may or may not reflect the foreign activities of the firm depending on the choices made by the firm, and includes subsidiaries owned at 80 percent or more. For these reasons it is unlikely that the value of unutilized tax credits and NOLs will be accurately capitalized by the stock market's valuation of the firm.[13]

Pre-1986 Limitations on the Purchase of Tax Attributes

The history of the federal corporate income tax can be characterized in aggregate terms as a game of chess between the IRS, the Congress, the courts, and taxpayers. At one extreme, the IRS has sought, through the regulatory process and litigation, to narrow access to the various incentives discussed above. The service has generally sought to limit the extent to which corporations can avoid the double-tier tax structure described at the outset of this chapter. At the other extreme, corporations, taxpayers, and their advisors have constantly sought new, innovative mechanisms to generate corporate source income tax-free at the corporate level, transmit it to the shareholder level, and transform such income into long-term capital gains.[14]

The Congress has, through amendments to the Internal Revenue Code, periodically reacted to reports of the worst abuse situations. The courts have played an uncertain role in refereeing the ingenuity of taxpayers, the reactions of the IRS, and periodic legislative attempts to plug the leaks (or chasms) in the fiscal dikes. Below, some of the limitations that have evolved up to 1986 are noted so that the reader does not simply conclude that the various tax-reduction mechanisms discussed above have gone completely unchecked.

Section 269: Acquisition for Tax Avoidance Prohibited

The federal tax attributes of a corporation continue from year to year, so that at any point in time a corporation has a tax history that may be attractive, as noted above. Section 269 was enacted in 1943 to deny the acquiring corporation or its shareholders the benefits, deductions, or credits to reduce its taxes if the principal purpose of the acquisition was the evasion or avoidance of income tax. As might be expected, substantial litigation ensued following the enactment of Section 269, as taxpayers and the service sought to demonstrate that the purpose of various corporate acquisitions was or was not tax avoidance.[15]

Section 382: Restrictions on Use of Target's NOLs by the Acquiring Corporation

In 1954, Congress added Sections 382(a) and 382(b) to the service's arsenal of weapons to defend against purely tax-motivated acquisitions.

Under Section 382(a), NOLs were denied entirely to the acquiring corporation if ten or fewer shareholders increased their holdings of the target firm by 50 percent or more over a 12-month period, if the stock purchase was from an unrelated person or from a decrease in the amount of stock outstanding, and if the target corporation did not continue to carry on the trade or business in substantially the same manner. NOLs were also denied to the acquiring corporation, under Section 382(b), if the shareholders of the target corporation (with NOLs) received less than 20 percent of the stock of the merged corporation.[16]

The enactment of Section 382 did not exhaust the available avenues for the ingenious to acquire tax-loss corporations and benefit from them, and until 1976 Congress struggled to find a legislative solution. As a part of the Tax Reform Act of 1976, Congress imposed a series of additional limitations that would have had the effect of eliminating many of the remaining incentives for so-called "trafficking" in tax losses that Section 382 failed to reach.[17] However, the effective date of the 1976 revisions to Section 382 was delayed repeatedly until passage of the Tax Reform Act of 1986.[18]

IRS Regs Section 1.1502–21: Rules Governing NOL Computations and Consolidated Returns

In general, when a group of affiliated corporations files their federal tax return on a consolidated basis, operating losses may be used to offset operating income from other members of the affiliated group. As subsidiaries report losses or profits, the balance sheet of each subsidiary is adjusted with upward-basis adjustments to reflect positive earnings and profits and downward adjustments to reflect losses.

A major thrust of these regulations has been to limit the availability of pre-acquisition losses of the target firm to the parent or group in subsequent time periods when the target firm has become part of the affiliated group. The losses incurred in the (prior) separate return limitation year (SRLY) can only be used to offset future income of the subsidiary once it has become part of the affiliated group. In effect, such prior losses are traced to income of the subsidiary once in the affiliated group, and allowed to offset such current income. Losses incurred by the subsidiary once within the affiliated group can, however, be used to offset income of other members of the consolidated group within the entire consolidated group to the extent that it has been a member of the group on a day-by-day basis.[19]

Federal Tax Characteristics of Pension Plans

Pension plans are generally of two types: defined-contribution or defined-benefit plans. Under a defined-contribution plan, the employer (and sometimes the employee) makes contributions into a pension trust in stated amounts. Subsequent retirement benefits depend on the success of such investments over time. Under a defined-benefit plan, the employer promises to make certain retirement payments to the employee in recognition for years of service and pattern of wages, and sets aside through pension contributions funds that actuarially should allow these obligations to be met. Typically, defined-benefit plans are not indexed for inflation; however, such benefits are often adjusted upward for the retirees in recognition of increases in the cost of living.

Such pension plans, if they meet a number of requirements of the Internal Revenue Code, are tax-exempt entities. This means that contributions by employers, which are a cost of doing business, and contributions by employees, which may be in the form of wage reductions, will grow in value in the pension trust without regard to taxation of such interest, dividend, or capital-gain income. This tax-free accumulation is typically called "tax deferral," since pension payments to retirees are taxable income.

This mechanism of tax deferral is of major consequence as the following example demonstrates. Consider a firm with $100 of pre-tax profits. If it wishes to reinvest the after-tax profits, and if the corporate tax rate is 46 percent, then it will be able to invest $54. Suppose that the market rate of interest is 10 percent. Since the interest income is taxable each year, the net annual yield is 5.4 percent. After 20 years, the firm will have accumulated $154.60 ($54 compounded at 5.4 percent for 20 years). Instead, let us suppose that the firm made an initial $100 payment into the pension plan. The firm would have no taxes due, since the pension payment is made as a corporate expense. Suppose now that in turn the pension plan invests the $100. Now the $100 will compound at 10 percent, since the pension fund is tax-exempt. In this instance, the firm through its pension plan will have accumulated $672.75 ($100 compounded at 10 percent for 20 years). These accumulations will continue to be tax-exempt as long as they remain in the plan. Were the pension fund to pay the firm the $672.75, the $672.75 would be taxed at the corporate tax rate of 46 percent. The firm would find itself with $363.28 in after-tax income. By contrast, had it invested after-tax dollars that were taxed each year, it would have earned only $154.60. The mechanism of tax deferral thus created a 240 percent increase in net, after-tax accumulation over the 20-year period.

In order for a pension plan to meet its legal obligations, contributions must be put into the trust and invested so that sufficient capital is available in income thereof to make retirement payments later on. Each year, the trustees of the pension trust must calculate whether the assets on hand are sufficient to meet the future obligations of the trust. However, in periods of rapid economic growth and boom periods in the stock market, a pension trust may find itself overfunded. If a firm is extremely conservative in its actuarial assumptions, it may in effect engage in a tax-free savings plan that may ultimately rebound to its advantage when it reverts the excess assets back to the firm. The extent of this advantage depends on: (1) the period of time over which such excess funding occurs, (2) when excess assets are put aside, and (3) the rate of interest that is earned in the pension trust.[20]

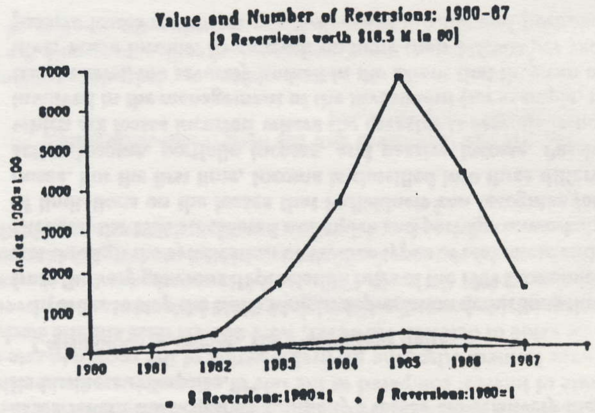
Until 1981, there was considerable uncertainty among business taxpayers whether such reversions could occur without serious consequences to current employees. In particular, it was not clear that an employer could:

1. Terminate its defined benefit plan;
2. Use the proceeds to buy annuity contracts for the existing retirees;
3. Set up a new, qualified pension trust for existing employees that was actuarially sound but not overfunded; and
4. Realize the excess assets as ordinary income.

At issue was whether an employer could set up a new pension plan that would be a qualified plan and thus tax-exempt under the Internal Revenue Code. However, in a suit involving LTV and one of its subsidiaries, the courts held in 1981 that such a process did not endanger the tax-exempt status of the new pension trust. In such circumstances, especially in the case of defined-benefit plans, which are more clearly the prerogative of the employer, it is within the legal right of the employer to terminate the plan and create a new plan with assets adequate to pay current and expected benefits. The excess profits from such a transaction are, however, ordinary income. To the extent that the termination and reversion of excess assets to the employer occur at times when the corporation may have tax losses or unused tax credits, the reversion may have no tax consequences to the employer.[21] Since the corporation controls the timing of the reversion, it may be able to plan it to coincide with a period of tax losses and excess tax credits.

The aggregate data on terminations and reversions available from the Pension Benefit Guarantee Corporation, which insures qualified private pension plans, indicate a dramatic increase in termination-and-reversion activity in the 1980s. In 1980, there were 9 terminations involving reversions; the total value of reversions was $18.5 million. In 1985, the high point of terminations in terms of numbers and amount of reversions, there were 580 terminations with reversions worth $6.67 billion. Figure 10.2 displays this information graphically with 1980 serving as the base year. Over the period 1980 through 1987, better than 1,600 plans terminated, with reversions totalling $18.1 billion.[22]

Figure 10.2
Terminations and Reversions of Single-Employer Pension Plans, 1980–1987



THE FUTURE OF FEDERAL TAX INCENTIVES FOR MERGERS AND ACQUISITIONS

There are many reasons why the Tax Reform Act of 1986 is generally viewed as a watershed in the development of federal tax policy. The wave of tax-motivated mergers of the 1980s mobilized Congress to face up to a wide variety of structural corporate tax issues that had been festering for many years. In order to understand how and why mergers and acquisitions may occur in the future, it is important to examine those features of the 1986 act (implicitly juxtaposed against the above discussion) that affect the merger decision. This section concludes with speculations about the future course of mergers and acquisitions.

Major Provisions of the Tax Reform Act of 1986

Elimination of the Capital Gains Exclusion

As of 1987, the historical exclusion of 60 percent of long-term capital gains from taxable income was eliminated by the Tax Reform Act of 1986 for individuals and corporations. As a consequence, the incentive to use the corporation as an intermediary in the acquisition of assets, or to transmit long-term gains to shareholders, was eliminated. It is likely that this will have several long-term effects: It will create greater interest in receiving current dividends on the part of shareholders, and will penalize or reward firms in terms of their share prices in the capital market to the extent that they pay or fail to pay competitive dividends.[23]

Lowering of Corporate and Personal Tax Rates

The top corporate rate was lowered to 34 percent from (46 percent), and the top marginal personal tax rate, after certain income-conditioned phase-outs are complete, will be lowered to 28 percent (from 50 percent) effective in 1988.[24] Both rates are about 45 percent lower than before the 1986 Act; however, note that the top corporate tax rate is now noticeably less than the top personal tax rate. This differential of six percentage points has led some closely held corporations to become Subchapter-S corporations whose economic characteristics flow through entirely to each shareholder. This lower tax rate means that the value of various types of deductions and tax shields has fallen by 44 percent for corporations and individuals. In effect, the government is sharing far less in the financing of debt-financed acquisitions, and the risk associated with such leveraging lies increasingly with the buyer.

In terms of the double taxation issue, under the new rate schedule, \$100 of corporate source income will be taxed \$34 at the corporate level (34 percent times \$100), and \$18.48 at the individual level (28 percent times \$66 of dividends) for a combined tax of \$52.48. This contrasts with a tax of \$28 were the \$100 earned at the personal level under the new tax rates. Recall that under pre–1986 law, the potential difference in effective tax rates was 23 percentage points; under the new rate structure it will be slightly larger, at 24.48 percentage points. On the other hand, because the capital gains exclusion was eliminated, the worst-case differential under pre–1986 law of 53 percentage points has been considerably narrowed to 28 percentage points or 25 percent.[25]

The elimination of the long-term capital gains exclusion coupled with the lowering of the corporate and personal tax rates reduces the incentive to try to find ways to exempt corporate source income at the corporate level and transform it to long-term capital gains at the individual level. In turn, this should reduce the interest on the part of shareholders to use the corporation as a surrogate investment shield. Also, lower personal tax rates mean that shareholders will be more anxious for current dividends than in the past; the elimination of long-term capital gains magnifies this.

Repeal of General Utilities *Doctrine*

Effective in 1987, Section 336 of the Internal Revenue Code was amended to require that, in general, gain or loss is to be recognized to a corporation on a distribution of its property in a complete liquidation. This, in effect, repeals the *General Utilities* Doctrine, and eliminates in turn a major tax incentive for corporations to acquire and dispose of other corporations. Hereafter such activities will have tax consequences at the corporate level, albeit at a lower, 34 percent marginal tax rate, and will not be subject to long-term capital gains treatment.

Revised Depreciation Rules

The highly accelerated depreciation schedules of 1981 were revised several times in the 1980s (1982 and 1984) and again in the Tax Reform Act of 1986. As a consequence, plant and equipment put in place in the future will not generate such large, early deductions for depreciation as in the past; however, investments put in place in the early 1980s will continue to benefit from the more generous treatment.

Trafficking in NOLs: Reform of Section 382

Space limitations preclude a systematic overview of the extent to which the revisions to Sections 381 and 382 have eliminated opportunities for a profitable firm acquiring a target firm's unused tax credits and operating losses. After an ownership change, annual limitations are imposed on the ability of the acquired corporation to benefit from pre-acquisition NOLs. The limitation is equal to a specified interest rate times the value of the target corporation's stock on the date of acquisition. Further, NOL carryforwards are disallowed unless the target firm maintains continuity of business for two years after the ownership change and certain ownership requirements are met. The practical effect of this rewrite of Section 382, in the view of Borris Bittker and James Eustice, is to "virtually eliminate any significant loss carry-over possibilities, except in those cases where the acquired company's losses are relatively incidental to its business enterprise."[26]

Classification of Income: The Passive Loss Rules

In order to stop the trafficking in depreciation deductions that resulted from the very generous depreciation rules of the 1981 Economic Recovery Act through the syndication of various types of real estate and other tax shelters, the 1986 act created a complex and perhaps unworkable system of limitations on the losses that individuals can recognize for tax purposes. For the first time, income is classified into three different types: active income, portfolio income, and passive income. Passive losses, which are losses incurred where the investor is essentially not actively involved in the management of the investment (for example, real estate tax shelters), are severely limited in the extent that they can offset positive, active income. In general, no more than $25,000 per year of such passive losses can offset positive, active income and portfolio income;

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however, this is phased out in cases of adjusted gross income between $100,000 and $200,000. This limitation becomes fully effective in 1991 for investments in pre-1986 tax shelters, and effective in 1987 for post-1986 tax shelters.

In addition, rules that limit personal interest deductions to the extent that an investor is economically at risk were extended to include real estate investments. Historically, interest deductions for non-recourse loans were permitted without limitation in the case of real estate investments; however, this opportunity to mismatch cash interest payments and accrued interest payments to generate current tax losses was eliminated in the 1986 Tax Reform Act. Also, the $10,000 pre-1986 allowance for personal interest deductions, available for those who itemized their individual tax returns, was eliminated.

Ten-Percent Excise Tax on Pension Fund Reversions

As noted, the termination of single-employer defined-benefit plans and reversions of the excess assets to employers became quite pronounced after 1981. In recognition of the growth in this tax-deferral technique, Congress enacted a new, non-deductible, 10-percent excise tax on the amount of reversion an employer may realize on termination of a qualified plan. Note that the excise tax is imposed on the amount of the fair market value of cash and property that the plan transfers to the employer. To the extent that the business is taxable, it must also treat receipt of transfers as ordinary income, although such transfers would be taxed at a 34-percent tax rate; in effect, such marginal income will thus be taxed at a combined tax rate of 44 percent, and for firms in a loss position at a minimum tax rate of 10 percent.

Whether this new excise tax adequately removes prior incentives depends on a number of factors, the most important of which is the market rate of interest compared to the rate of return incurred when the plans were formed. Also, the general lowering of the corporate rate reduces the value of deferral. However, were interest rates and the stock market to again rise generally, these plans could look substantially overfunded as they did in the early 1980s, and it is conceivable that the excise tax of 10 percent combined with the use of NOLs to offset the income being returned to the employers will be insufficient to encourage further plan terminations and reversions.

Federal Tax Incentives and the Merger-and-Acquisition Decision: Some Forecasts

It is instructive now to examine where our federal tax system stands vis à vis the various incentives discussed earlier along with the Internal Revenue Code of 1986. Let us first examine the taxation of $100 of corporate source income compared to the taxation of $100 personal income in a post–1986 world: Under the two-tier system, a tax of $34 will be levied at the corporate level, and the $66 of dividends will be taxed at a top marginal rate of 28 percent or $18.48 of tax, for a combined tax of $52.48; this contrasts with a levy of $28 on $100 of personal income under the individual income tax. Thus, the effective tax rate of the two-tier system is 52.48 percent, while the effective tax rate of the single tax system is 28 percent, with a differential of 24.8 percent in place. This is somewhat larger than under prior law, when the differential was 23 percent.

While the overall level of tax rates is lower, the differential between the double-tax system and the single-tax system is about the same. Before, as I have shown, there were additional opportunities to take the double tax and reduce it below the single-tax system by virtue of taking advantage of the *General Utilities* Doctrine and the favorable treatment of long-term capital gains. It would appear, however, that currently such opportunities to avoid the double tax have been effectively eliminated, and the incentive to use corporations as a mechanism to translate ordinary income into long-term capital gains is now gone. As such, one set of incentives for mergers and acquisitions in federal tax law is now gone.

This does not mean, however, that incentives do not remain. Since interest remains deductible while dividends are not, the analysis of the tax advantage of debt financing remains intact. If we return to the example showing the effect of debt financing on the after-tax yield to shareholders in the previous section, we find that both after-tax returns have increased as a result of the corporate tax rate having dropped from 46 to 34 percent. Since the new rate is the same for both firms, it follows that the differential in after-tax returns remains the same in percentage terms, although it has widened in absolute terms. With a corporate rate of 34 percent, the all-equity firm will pay $68 of tax on $200 of operating income, and report an after-tax return to its shareholders of 13.2 percent ($132 of after-tax income divided by $1,000 of shareholder equity). Our 50-percent debt-financed firm will now pay $44.20 of tax on $130 of operating income, and report an after-tax return to its shareholders of 17.16 percent ($85.80 of after-tax income divided by $500 of shareholder equity). The difference in rate of returns is now larger than before (compare an absolute difference of 3.24 percentage points under the prior law to an absolute difference of 3.96 percentage points under the new regime), but the differential in relative terms remains at 30 percent.

This suggests that highly debt-financed takeovers will continue as in the past, especially takeovers of those firms that are not already highly leveraged. Firms with unutilized NOLs and tax credit carryforwards will be less attractive as takeover candidates because the Tax Reform Act of 1986 increased the neutrality of the tax system with regard to those classes of businesses. Firms with overfunded pension plans will not be as attractive as before, although whether a 10-percent excise tax is enough to dissuade interest for this reason remains to be proven. In view of the fact that the Congress now has before it proposals to raise the rate to 60 percent, it may be that firms with such characteristics will remain attractive. Since the current amount of overfunding may still be in excess of $200 billion, one should not rule out the possibility that the searchlight for takeover firms will focus increasingly on pension trusts, if for no other reason than the fact that other opportunities for quick cash flow have diminished as a result of the 1986 legislation.

I should like to close with a prediction that does not have a strong analytical base but that may nonetheless prove correct. As we have seen, prior to 1986 the double taxing of corporate source income created, through the courts and through legislation, a wide variety of vehicles for escape. We have also seen that the 1986 act seems to have closed down all the historically known ways to escape the double tax, and indirectly has reduced if not eliminated many of the raw federal tax incentives for mergers and acquisitions. It is my conjecture that, through a combination of pressures (ingenuity of the tax professionals, eccentricities of our courts, and even future action by Congress if replacement revenues can be estimated to be found) relief from the double taxation of corporate source income will be found again. If this conjecture is correct, it is reasonable to surmise that the corporate veil will be increasingly used again for tax-motivated mergers and acquisitions.

NOTES

1. This figure is reported by the publication *Mergers and Acquisitions* (May/June 1988): 45, and represents 3,701 transactions that involved a U.S. company valued at $1,000,000 or more.

2. Undoubtedly this increase in overseas interest in domestic firms mirrors the drop in the value of the dollar relative to other major currencies, and has had the beneficial effect of helping to finance our enormous balance-of-trade deficit since investments into the United States are measured as exports of capital and offset our adverse merchandise trade deficit.

3. Throughout this section, reference is made to the "historical" provisions of the Internal Revenue Code. In general, this means provisions prior to the results of the 1986 Tax Reform Act taking effect.

4. See Pechman (1987), Appendix A, for a useful historical table of statutory personal and business tax rates, 1913–1987.

5. The reader may object to the realism of this example, since historically many firms have not faced effective tax rates of 46 percent, and dividend recipients have had access to small but nonetheless important dividend exclusions of $100 for single taxpayers and $200 for married taxpayers filing jointly. However, in order to understand taxpayer behavior, it is crucial to understand that

the fundamental double taxation of corporate source income is the starting point for tax-planning decisions.

Whether such potential double taxation is appropriate raises a number of essentially philosophical issues. Since the corporation is legally a separate "person," it may be argued that it has a separate ability to pay. Irrespective of having a separate ability to pay, it may be further argued that the corporation enjoys a number of public services for which it has an obligation to pay, irrespective of whether there is a corporate "veil" between the corporation and the shareholder. On the other hand, the taxation of intangible corporate wealth at the shareholder level could, arguably, be viewed as adequate payment for such public services. Furthermore, in a competitive world economy, it may be argued that such double taxation drives domestic corporate investment overseas where it may be more favorably taxed.

6. That is, a top rate of 50 percent times the residual of 40 percent which was taxable amounted to a top tax rate of 20 percent; the corresponding rate for corporations prior to 1986 was 28 percent.

7. *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

8. Thus, when the shareholders sold the stock for $1 million to the prospective buyer, the transaction was regarded as a wash transaction at the corporate level.

9. Gulf Oil's failure to create and then spin off a separate trust to hold its substantial oil reserves led one raider to unsuccessfully attempt to take over the company. He promised that he would sell off the trust, owning such property through a liquidation in such a manner that would result in taxation at the shareholder level only at long-term capital gains rates, and none at the corporate level.

10. This example is drawn from U.S. Congress (1985), pp. 11–12.

11. This is not to suggest that there was no economic rationale for such a change in depreciation rules, especially in light of the rapid inflation of the 1970s which eroded the real value of depreciation deductions from earlier investments. However, the radical change in depreciation rules significantly affected the size of the federal corporate tax base for a number of years, and resulted in a complete revision again in 1986. This enormous increase in depreciation deductions for real property had the predictable effect of creating a commercial-property construction boom and the creation of widely syndicated partnerships in such buildings so individuals could share in these tax shields at the individual income tax level.

12. The incentives are much more complex than this as the Congress and the courts have been mindful that such losses can readily allow sizeable tax reductions for taxable firms. Some of the limitations on such tax-motivated mergers will be discussed, as well as the restrictions put in place by the Tax Reform Act of 1986.

13. These observations may explain the general lack of statistical relationship between the merger-and-acquisition decision and tax considerations found by Auerbach and Reishus (1988a, 1988b).

14. Given wide disparities in marginal tax rates between the corporate and individual levels, and the aforementioned two-tier structure of taxation for cor-

porate source income, this sort of effort can only be viewed as rational, tax-minimizing behavior.

15. See Bittker and Eustice (1987), pp. 16–42 through 16–46.

16. The 20 percent floor explains the nature of the LBO example used above, and why up to 80 percent of the purchase can be borrowed without endangering the ability of the acquiring corporation to obtain the NOLs of the target firm.

17. For example, Sections 269 and 382 failed to reach the loss corporation, which acquired a profitable corporation so that the profitable target could then reduce its taxes by virtue of becoming a part of the loss corporation—the so-called "minnow swallowing the whale" strategy.

18. See Bittker and Eustice (1987), pp. 16–60 through 16–70, for the legislative history of the 1986 provisions of Section 382 as well as a lucid discussion of it. See also, Bacon and Tomasulo (1983) for an appraisal of various proposals to limit trafficking in NOLs in the 1970s as well as their own suggestion to reform Section 382.

19. The issue of how one computes profits and losses of members of an affiliated group is not, however, without its own difficulties. Since many transactions within a corporation take place at prices and costs that it sets for itself, there are opportunities for the creation of certain types of accounting losses that may circumvent the aforementioned limitations. On the other hand, the Congress, Treasury, and IRS have been mindful of such tactics, and Section 482 of the code, which deals with the pricing of such intracompany transactions, seeks to impose arms-length standards for such pricing calculations to thwart tax avoidance. Where market prices are not available for comparison or audit purposes, the development of reasonable pricing rules is inherently problematical, and is the source of continuing conflict between the IRS and business taxpayers.

20. See Ippolito (1985), chapter 13, and Ippolito (1986) for instructive calculations on the value of deferral to employers and the federal government.

21. It should be remembered that such termination and reversion of excess assets is only available for single-employer plans and is not available under multi-employer plans, which are covered under the Taft Hartley Act.

22. Pension Benefit Guarantee Corporation, *Annual Report to the Congress, Fiscal Year 1987*, p. 12.

23. While the elimination of the apparatus of capital gains was one of the major features of the 1986 act, and perhaps justified the renaming of the Internal Revenue Code of 1954 to the Internal Revenue Code of 1986, the Congress was sufficiently unsure of itself that it left all provisions of pre–1986 law in the new code, simply rendering them inoperative. Restoration of the capital gains exclusion was an important presidential campaign issue in 1988.

24. Recall that in 1987 a transitional set of personal tax rates were in effect with the top marginal rate being 38.5 percent.

25. That is, compare the combined rate of 73 percent from Table 10.1 to just the long-term personal capital gains rate of 20 percent.

26. Bittker and Eustice (1987), p. 16–68.