Tax Reform and the Merger and Acquisition Market: The Repeal of *General Utilities*

The 1986 Tax Reform Act repeals the so-called *General Utilities* doctrine—the principle that corporations liquidating their businesses are not subject to capital gains tax on the appreciation in the value of their assets [1] This change, along with the new corporate tax rate structure, reduces the benefits and raises the costs of many mergers and acquisitions (M&A's), especially those involving firms with undervalued assets The repeal of *General Utilities* takes effect after the end of 1986 (except for generous transition rules), and along with other tax changes, may help to explain the surge in M&A activity in the second half of 1986 (Chart 1).[2]

A liquidating corporation, using *General Utilities*, escapes the tax liability that comes with appreciated assets. This can be an important element of a liquidation, since the purchaser of the firm's assets will wish to acquire them with an increased (stepped-up) tax value (basis) in order to claim larger depreciation and depletion allowances Ordinarily, a step-up implies that a corporation will incur a capital gains tax liability (the corporate capital gains tax rate, currently 28%, will rise to 34% in 1987)

General Utilities is relevant to the M&A market because, under Section 338 of the Internal Revenue Code, the purchaser of at least 80% of the stock of a corporation may treat the transaction, for tax purposes, as liquidation of the corporation and purchase of its assets [3] By using *General Utilities* and Section 338, a corporation can obtain the advantages of a basis step-up without paying capital gains tax and without truly liquidating assets—a firm can stay in the same business with the same capital stock, managers, and workers. The tax saving arises solely from the change in ownership of a firm's stock The prospect of such tax savings has been an important spur to the M&A market

A step-up in the basis of an acquired firm's assets may not always be in a purchaser's interest, however. Even though an acquired firm escapes capital gains tax on the appreciation of its assets, it still has to pay tax on that part of the basis step-up that represents the "recapture" of past depreciation allowances. That is, because depreciation allowances are intended to capture the decline in an asset's value, sale of an asset for an amount greater than the depreciated book value implies that allowances taken in the past overstated the

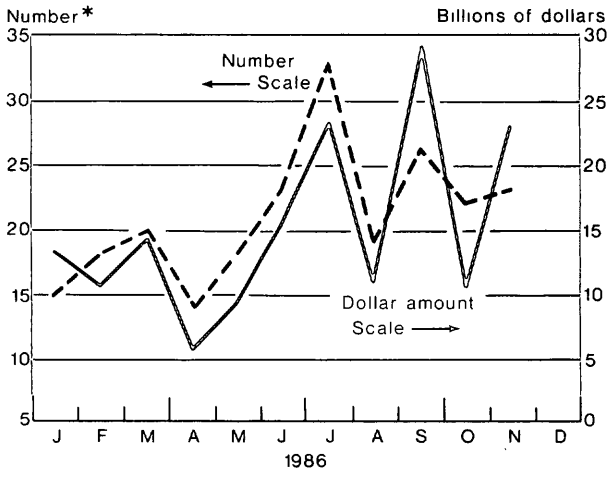
[1]The *General Utilities* doctrine derives its name from a 1935 Supreme Court case, *General Utilities and Operating Co v Helvering* The Court's decision in the case was ultimately incorporated into the Internal Revenue Code For an overall look at the pre-reform tax implications of mergers, see Joint Committee on Taxation, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985

[2]Other elements of tax reform have affected M&A activity The January 1, 1987 increase in the personal long-term capital gains tax rate—raising the maximum from 20% to 28%—created an important incentive to accelerate the completion of sales from 1987 to 1986 New rules on the transfer of net operating loss carryforwards and changes in the corporate minimum tax will make complex changes to the tax implications of many proposed mergers, favoring some and impeding others

[3]The transaction must subject the selling shareholders to capital gains tax on the appreciated value of their stock In general, a takeover involving the exchange of securities for stock is not taxable while a cash purchase is

Chart 1

Large Stock Transactions



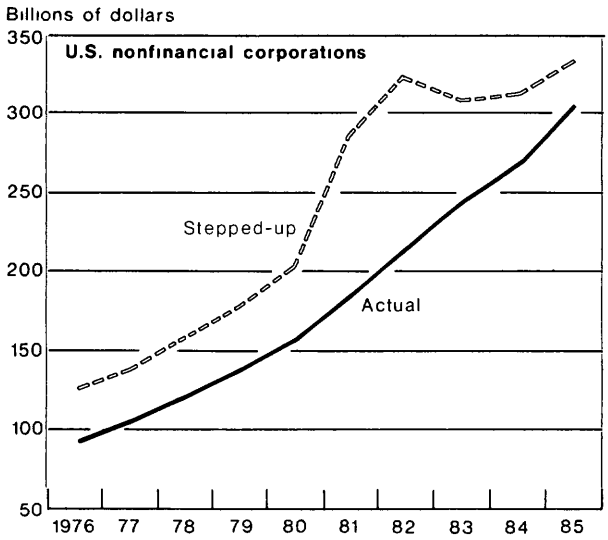
Includes publically-disclosed transactions completed or currently pending for stock or assets of U S nonfinancial corporations Data through November 19, 1986

*Dollar amount greater than $250 million

Source Securities Data Company

Chart 3

Actual Depreciation Compared to Depreciation on a Stepped-up Basis

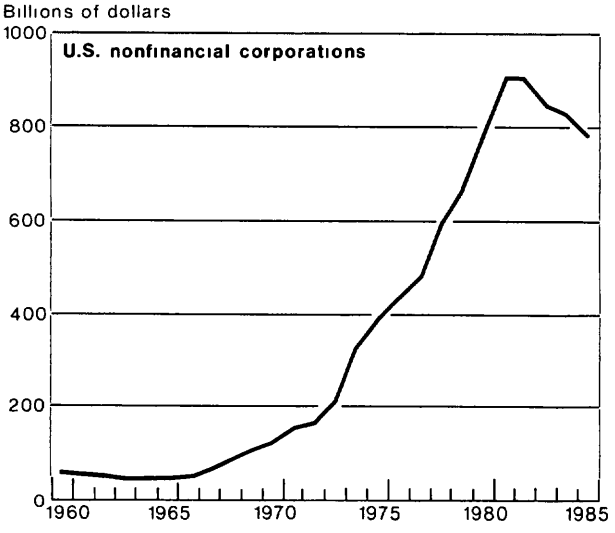


Source Federal Reserve Board, Flow-of-Funds, Federal Reserve Bank of New York staff estimates

Chart 2

Fixed Reproducible Tangible Assets

Current cost less historic cost



Source Federal Reserve Board, Balance Sheets for the U S Economy 1946-1985, October 1986

true decline in value. This recapture tax may offset the advantages of the basis step-up.[4]

Because detailed study of a corporation's assets is often necessary to calculate the costs and benefits of a basis step-up, purchasers are allowed one year to decide on carrying out a Section 338 liquidation. In the case of those buyouts involving a firm's management, the acquirers are likely to know the costs and benefits of a Section 338 liquidation well in advance of sale. Although the Treasury Department has no data on the overall use of Section 338, the device seems to be used often in the aftermath of leveraged buyouts.

But in general, Section 338 and *General Utilities* is more advantageous the greater the proportion of the acquired firm's overall purchase price that can be assigned to its depreciable and depletable assets, and the larger the basis step-up relative to the original cost of the assets. Many firms in the manufacturing and natural resource sectors fit this description. The inflation of the 1970s greatly increased the difference between the market value of tangible corporate assets and their tax basis, and in conjunction with the acceleration of depreciation schedules in 1981, allowed for dramatically increased depreciation allowances on existing assets.

[4]Investment tax credits and certain other deductions, along with depreciation, are also recaptured

The wave of large-scale mergers and leveraged buyouts in the last few years, especially in manufacturing and mining, is partly due to the attraction of the tax-free basis step-up under Section 338 and *General Utilities*.

During the high-inflation era of the late 1970s and early 1980s, the potential size of basis step-ups surged. Chart 2 plots the difference between the value of nonfinancial corporate plant and equipment on a current (or reproduction) cost basis and on a depreciated historic cost basis. Current cost can be considered an approximation of market value and historic cost an approximation of the basis.[5] While these approximations are rough, the difference between the two provides an indication of the potential amount of step-up available on plant and equipment. The chart shows that the potential step-up did increase substantially in the 1970s, peaking at nearly $1 trillion in 1981 The discrepancy has been reduced somewhat in recent years as old, undervalued capital has been retired from service.

[5]The historic cost data used in Chart 2 are derived from expenditures on new capital and straight-line depreciation schedules The tax basis of capital would be calculated from expenditures on new and used capital and actual depreciation schedules, which can be considerably different from hypothetical straight-line schedules Thus, the historic cost data is likely a very rough approximation of the true basis

Table 1

Effect of Merger (Before Tax Reform)

	Pre-merger	Post-merger*	
First year			
Cashflow from operations	$2,000,000	$2,000,000	
Depreciation	$ 500,000†	$3,850,000	
Interest	$ 0	$2,200,000	
Pre-tax profits	$1,500,000	($4,050,000)	
Taxes	$ 690,000	($1,863,000)	(on profits)
		+ $1,380,000	(on recaptured depreciation)
		=($ 483,000)	
After-tax cashflow‡	$1,130,000	$ 283,000	
Following years			
Cashflow from operations	$2,000,000	$2,000,000	
Depreciation	$ 500,000	$3,850,000	
Interest	$ 0	$2,200,000	
Pre-tax profits	$1,500,000	($4,050,000)	
Taxes	$ 690,000	($1,863,000)	
After-tax cashflow‡	$1,310,000	$1,663,000	
Present value of after-tax cashflows§	$5,518,197	$5,703,274	

*Purchase price $22 million, financed at 10%
†Original purchase price $10,000,000, current basis $7,000,000
‡Cashflow from operations less interest and taxes
§Years 1 to 5, evaluated at a 6% rate

A firm will wish to step up the basis of assets to obtain higher depreciation allowances. Chart 3 plots the actual depreciation allowances taken by nonfinancial corporations in the last decade and compares them to an estimate of the first year's allowance that could be obtained by stepping up the basis of plant and equipment to current cost, and depreciating under prevailing rules. The potential benefit of a step-up gradually increased during the late 1970s as inflation heated up. More importantly, the sharp reduction in taxable service lives introduced in 1981 dramatically increased the tax advantages of a stepped-up basis [6] In conjunction with the post-1982 decline in interest rates, which reduced the cost of raising the funds used to finance takeovers, this opportunity to accelerate depreciation and avoid capital gains tax has probably facilitated many mergers

An example can illustrate in more detail how the specific characteristics of the pre-reform tax law contributed to the feasibility of certain deals. The target corporation described in Table 1 purchased its assets for $10,000,000, and its current basis in these assets is $7,000,000. The company's pre-tax profit (cashflow from operations less interest and depreciation) is $1,500,000, and it pays taxes at the pre-reform 46% rate [7]

The stock of the target is purchased by another corporation for $22,000,000 The acquirer borrows this money at 10% The tax basis of the acquired firm's assets is stepped up from $7,000,000 to $22,000,000, and using post-1981 rules, the depreciation rate on these assets is increased from 5% to 17 5% (for simplicity, depreciation is assumed to be on a straight-line schedule) [8] Thus, the annual depreciation deduction rises from $500,000 to $3,850,000. The increase in

Footnote 5 continued

[6]The hypothetical depreciation line in Chart 2 is based on the first year's depreciation from accelerated schedules The depreciation deductions in subsequent years tend to decline In present value terms, the depreciation benefits enacted in 1981 were less substantial than the surge in the hypothetical line may suggest

[7]For simplicity, the slight progressivity in the corporate tax schedule is ignored

[8]A reasonable estimate, one used in the Federal Reserve Board's macroeconomic model, is that the useful life of equipment for tax purposes was reduced from an average of 10 5 years prior to 1981 to 4 6 years today, and structures from 40 years to 19 years Thus, the example's assumption of a 12 5 percentage-point increase in the tax depreciation rate is a bit high, but not unrealistic On a straight-line basis, the first-year depreciation rate on a capital stock equally divided between equipment and structures is now 14% as compared to 6% prior to 1981 Tax reform will increase the useful life of most structures to 30 years and slightly increase the lives of some categories of equipment These changes will further reduce the attractiveness of stepping up the basis of assets following a merger

depreciation, coupled with the interest expense of the borrowed money, results in a deduction against the acquirer's earnings of more than $4 million and a credit of nearly $2 million against its tax liability

In the year following the merger, the target firm (which is technically selling its assets to the acquirer) will have to pay tax, at the ordinary corporate rate of 46%, on $3 million worth of recaptured depreciation [9] This tax reduces the combined firm's tax credit in the first year after the merger to just under $500,000; the after-tax cashflow accruing to the combined firm from the financing of the takeover and the operation of the acquired firm will be $283,000. In the following years the after-tax cashflow will amount to $1 7 million—larger than the flow to the target firm before the merger, despite the rise in interest expense associated with financing the deal

In present value terms, over a five-year horizon the after-tax cashflow these assets yield to the combined firm is greater than that to the target before the merger (The 6% discount rate used is arbitrary, but is roughly the after-tax return earned by a high-income individual who can invest 10% pre-tax and pays federal, state, and local income tax) Thus, if equity markets price according to five-year expectations, the equity value of the combined firm will be greater than the sum of the equity values of the two firms before merger. This comes about even though no increase in the cashflow from operations of either firm has been assumed, and even though interest on the debt raised to finance the purchase exceeds the cashflow from the acquired firm's operations After six years, when the depreciation allowances are assumed to expire, the merged firm will need to augment its cashflow, sell assets, or refinance

Table 2

Effect of New Tax Rates (*General Utilities* Doctrine Intact)

	Pre-merger	Post-merger	
First year			
Pre-tax profits	$1,500,000	($4,050,000)	
Taxes	$ 510,000	($1,377,000)	(on profits)
		+ $1,020,000	(on recaptured depreciation)
		=($ 357,000)	
After-tax cashflow*	$1,490,000	$ 157,000	
Following years			
Taxes	$ 510,000	($1,377,000)	
After-tax cashflow*	$1,490,000	$1,177,000	
Present value of after-tax cashflows†	$6,276,422	$3,995,688	

*Cashflow from operations less interest and taxes
†Years 1 to 5, evaluated at a 6% rate

[9]The actual rules on depreciation recapture are more complex than those in the example Furthermore, the example ignores the recapture of any investment tax credit taken on the purchase of these assets

Table 3

Effect of *General Utilities* Repeal

	No change in tax rates			New tax rates		
	Pre-merger	Post-merger		Pre-merger	Post-merger	
First year						
Pre-tax profits	$1,500,000	($4,050,000)		$1,500,000	($4,050,000)	
Taxes	$ 690,000	($1,863,000)	(on profits)	$ 510,000	($1,377,000)	(on profits)
		+ $1,380,000	(on recaptured depreciation)		+ $1,020,000	(on recaptured depreciation)
		+ $3,360,000	(on $12 million capital gain)		+ $4,080,000	(on $12 million capital gain)
		= $2,877,000			= $3 273,000	
After-tax cashflow*	$1,310,000	($3,007,000)		$1,490,000	($3,923,000)	
Following years						
Taxes	$ 690,000	($1,863,000)		$ 510,000	($1,377,000)	
After-tax cashflow*	$1,310,000	$1,663,000		$1,490,000	$1,177,000	
Present value of after-tax cashflows†	$5,518,187	$2,533,463		$6,276,422	$ 141,914	

*Cashflow from operations less interest and taxes
†Years 1 to 5, evaluated at a 6% rate

to cover the interest expense. In effect, the increase in depreciation expense gives the combined firm a long grace period to achieve operating economies.

Tax reform greatly reduces the incentives for this transaction to take place, both by changing the corporate tax rate structure and by repealing *General Utilities*. Table 2 shows the effect of reducing the corporate tax rate from 46% to 34%. The after-tax cashflow of the target firm rises (because its tax bill falls), while that of the merged firm falls (the after-tax value of the interest and depreciation deductions declines as the tax rate falls). The present value of the cashflow of the combined firm falls below the sum of the cashflows of the two firms separately.

Repeal of *General Utilities* sharply reduces the value of the combined firm (Table 3). The end of *General Utilities* means that capital gains tax is levied on the $12 million of the basis step-up that is not subject to recapture tax. The first year after-tax cashflow of the combined firm falls substantially, given the pre-reform corporate capital gains tax rate of 28%. Moreover, combining the new tax schedule (which, as mentioned above, includes a 34% rate on corporate capital gains) with the repeal of *General Utilities* produces a discounted cashflow for the combined firm only slightly larger than for the acquirer alone.

This example overemphasizes the impact of the *General Utilities* doctrine and its repeal—M&A activity is also motivated by non-tax factors and tax considerations other than depreciation. Nonetheless, elimination of *General Utilities* may harm investors who have taken positions based on the assumption that a corporation will be liquidated, since the end of *General Utilities* will raise the costs of liquidation. It is not clear how great the impact will be, and whether any investors will experience outright losses. On the other hand, tax reform could cause buyers to be more interested in the underlying earnings potential of merger candidates than in their tax attributes.[10]

[10]Repeal of *General Utilities*, along with the increase in the personal capital gains tax rate, may also mean that cash deals—which are usually necessary to use Section 338 but subject selling shareholders to capital gains tax—will become less common

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