

CHAPTER

16

TAX-FREE ACQUISITIONS OF FREESTANDING C CORPORATIONS

After completing this chapter, you should be able to:

1. Describe the four basic types of tax-free acquisitions of freestanding C corporations and the requirements for tax-free treatment.
2. Identify the tax consequences for the acquirer, the target, and the target's shareholders of various tax-free acquisition structures.
3. Compare the tax and nontax costs and benefits of taxable and tax-free acquisitions of freestanding C corporations.
4. Quantify the differential tax effects of taxable and tax-free acquisitions of freestanding C corporations.
5. Compute the prices at which a seller and an acquirer are indifferent between various taxable and tax-free acquisition structures holding nontax factors constant.

In the last two chapters we concentrated on taxable acquisitions of freestanding C corporations and taxable acquisitions of S corporations, respectively. Under all taxable structuring alternatives, the target's shareholders will face an immediate tax liability.¹ If the parties can agree to combine in a tax-free transaction under Tax Code Section 368 or Section 351, the target's shareholders avoid recognizing a current capital gain on the transaction. The buyer will also have access to the target's tax attributes, with some limitations, in a tax-free reorganization. However, in a tax-free acquisition, it is not possible to step up the tax basis of the target's assets.

In this chapter, we discuss various types of tax-free reorganizations under Section 368 and Section 351. We focus exclusively on tax-free acquisitions of freestanding C corporations in this chapter. The term *tax-free* is actually a misnomer because these

¹As noted in Chapter 14, in some cases installment sale treatment may provide tax deferral.

transactions provide target shareholders with tax deferral of the gain on the acquisition, not tax-free treatment. In this chapter we discuss and analyze tax-free acquisitions using several numerical examples similar in nature to those in the prior two chapters. We also analyze the limitations imposed on a target's tax attributes by Section 382 in carryover basis transactions. Finally, we develop a formal algebraic model that quantifies the tax consequences of taxable and tax-free acquisition structures for the acquirer, the target corporation, and the target's shareholders. We use the model to compare the costs and benefits of various tax-free acquisition structures, relative to taxable transactions. We defer our discussion of tax-free acquisitions of corporate subsidiaries until Chapter 17.

16.1 BASIC TYPES OF TAX-FREE REORGANIZATIONS

Of the four basic tax-free methods to acquire a freestanding C corporation, three are defined under **Section 368(a)(1)**. These three types are commonly known as **"A," "B," and "C" reorganizations**. The name is drawn from the subsection of Code Section 368(a)(1) under which each is defined; for example, Section 368(a)(1)(A) is the "A" form. The major differences between these reorganization structures relate to whether assets or stock is acquired and to the quantity and type of consideration required for tax-free treatment, such as at least 50% acquirer stock. Two variants of the Section 368 reorganization, known generally as **triangular mergers**, use a subsidiary of the acquiring firm to facilitate the acquisition. The fourth type of acquisition is defined by Section 351, which specifies the conditions under which a **corporate formation** will qualify for tax-free treatment.² Under any of these tax-free reorganization structures, target shareholders must recognize a taxable gain to the extent they receive cash or other forms of boot. Boot is broadly defined as cash and debt-type securities.

As we describe and contrast the various tax-free reorganization structures in this chapter, we will focus on the tax consequences of the structure to the acquirer, the target firm, and the target's shareholders. We pay particular attention to the resulting tax basis in the property transferred and received among these three parties.

First, we describe the general requirements for tax-free treatment in a merger. We then provide a detailed explanation of various types of tax-free reorganizations. Table 16.1 provides an overview of the tax consequences of the tax-free acquisition structures discussed in those sections.

General Requirements for Tax-Free Treatment under Section 368

In order to qualify as tax-free under Section 368, an acquisition has to meet several general requirements. First, target shareholders must maintain a continuity of interest in the assets of the target. For practical purposes, continuity of interest simply means that target shareholders must receive stock of the acquirer in return for their target shares.³ Historically, the minimum amount of acquirer stock necessary to qualify for

²A merger can be structured as a corporate formation transaction.

³By obtaining acquiring firm stock, target shareholders maintain an interest in the target's assets—a so-called continuity of interest.

TABLE 16.1 Overview of Tax-Free Acquisition Structures of Freestanding C Corporations

Triangular				
	I.R.C. §368 "A" (1)	I.R.C. §368 "A" (2)	I.R.C. §368 "B" (3)	I.R.C. §368 "C" (4)
Consideration/ method of payment required for tax-free treatment	At least 50% acquiring firm stock. Stock can be voting, nonvoting, preferred, or common.	At least 80% acquiring firm stock, must be voting stock.	100% acquiring firm voting stock, stock can be preferred or common.	Mixed consideration including stock, debt and cash. Transferees must receive stock of Newco and control Newco to qualify for tax-free treatment.
What is acquired?	Assets	Assets	Stock	Stock or Assets
Primary benefits	(1) flexibility of consideration (2) tax-free treatment for some target shareholders while providing cash to up to 50% of shareholders	(1) some liability shield provided by subsidiary (2) avoids acquirer shareholder vote (3) assets of target that would not transfer can be acquired (reverse triangular merger)	(1) simplicity and low transaction costs (2) target becomes a subsidiary of the acquirer providing some liability protection from target's liabilities (3) all assets of the target are acquired (e.g., licenses)	(1) very flexible in terms of providing target shareholders with desired form of consideration (e.g., cash or stock)
Primary costs	(1) assumption of all of the target's liabilities (2) some assets do not transfer (3) must qualify as a merger under state law	(1) restriction on type and quantity of stock considera- tion (2) must qualify as a merger under state law	(1) very restrictive rules with respect to consideration (2) all of the target's liabilities survive (3) dilution of the acquiring firm's shareholder control	(1) can be complex structure that gen- erates numerous tax and nontax issues that are not present in other structures

(1) Statutory merger in which the acquirer exchanges stock and boot with the target corporation in return for the target's assets and liabilities. The target liquidates and distributes the acquirer stock and boot to its shareholders in return for their target stock. (2) In a triangular statutory merger, the acquirer establishes a wholly owned subsidiary which exchanges acquirer stock and possibly some boot for the target's assets and liabilities. In this manner, the assets and liabilities of the target are held in a corporate subsidiary of the acquirer. (3) Stock for stock merger in which the acquirer directly exchanges its stock with target shareholders in return for their target stock. (4) A stock for asset merger that is similar to a statutory merger in form. (5) A corporate formation transaction in which the target corporation contributes stock or assets to a newly formed entity in return for stock and boot. Simultaneously, the acquirer contributes stock or assets to the new company in exchange for stock of the new company. The transaction is tax-free, to the extent of stock received, if it qualifies under §351.

tax-free treatment was 50% of the total acquisition consideration.⁴ As we will discuss, certain types of transactions under Section 368 impose additional restrictions on the form and percentage of total consideration required for tax-free treatment.

Second, an acquirer cannot purchase a target company in a tax-free transaction and then liquidate the target's assets. This principle of **continuity of business interest** means that the acquirer must continue to use the assets of the target in a productive capacity postacquisition. The acquirer can, however, dispose of some of the target's assets after the transaction is completed. In fact, in some cases, for regulatory reasons, acquirers must sell off portions of the target's business. It is also important to note that the acquirer need not use the target's assets in the same business in which the target operated. The acquirer must simply use those assets in a productive capacity. Finally, the acquisition must have a valid business purpose and cannot be motivated purely as a mechanism to avoid tax. We next discuss specific types of tax-free acquisitions, requirements for tax-free treatment under each structure, and the tax implications of each structure.

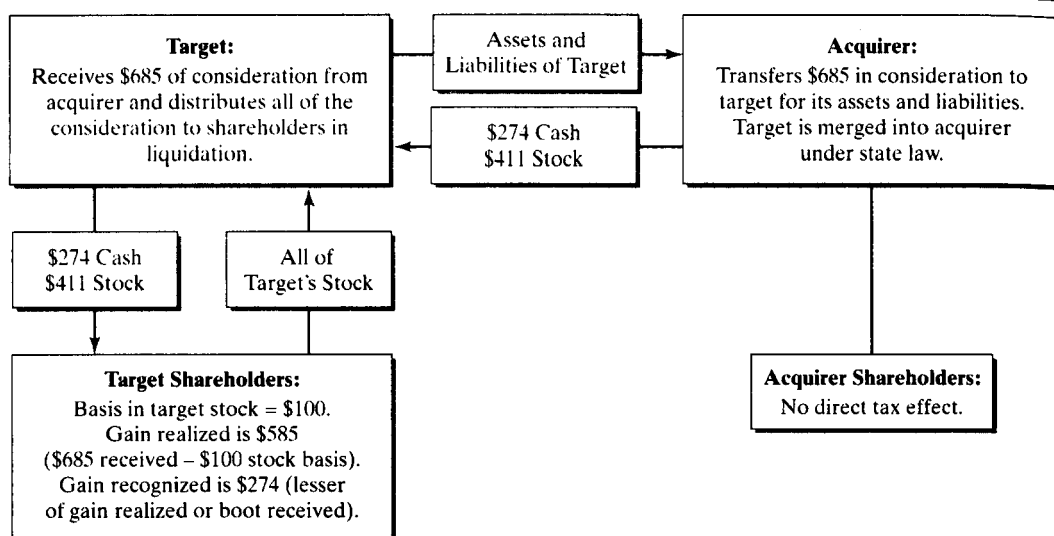
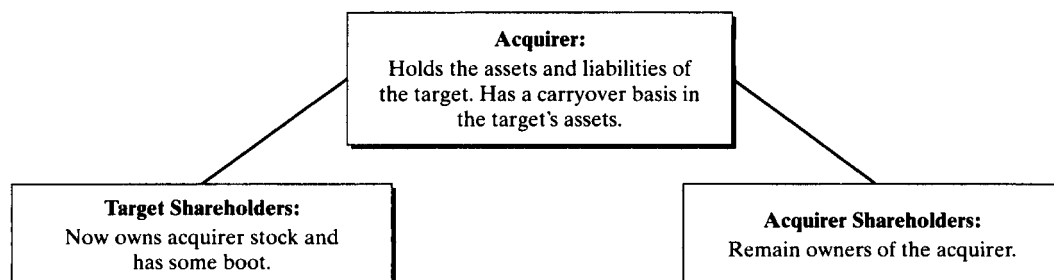
16.2 SECTION 368 "A" REORGANIZATION: STATUTORY MERGER

Under a **Section 368 "A" reorganization**, which is depicted in Figure 16.1, the acquirer exchanges its stock and possibly some boot (e.g., cash) for the assets and liabilities of the target. The target corporation must distribute the consideration received from the acquirer to its shareholders in return for their target stock in liquidation. The **liquidating distribution** is tax-free as long as target shareholders receive stock of the acquirer. If they receive cash, the cash is taxable even if the transaction is tax-free. Specifically, target shareholders recognize a taxable gain that is the lesser of the gain realized or the boot received. Gain realized is computed as the difference between the purchase price (value of consideration received) and the selling shareholder's tax basis in the stock. Losses realized are not recognized, however. After the transaction, shareholders of the target become shareholders of the acquirer, which postmerger owns the assets of the target.

Requirements to Qualify for Tax-Free Treatment under Section 368(a)(1)(A)

"A" reorganizations must qualify as **statutory mergers** under applicable state law. As a result, the merger must be approved by both the acquirer's and the target's shareholders. For tax purposes, an "A" reorganization generally requires that at least 50% of the total consideration received by target shareholders in the acquisition is acquirer stock. Acquirers can use either voting or nonvoting stock to meet the continuity of interest test and they may also use either common or preferred stock.

⁴Several transactions in which only 40% of the consideration was acquirer stock have, however, qualified for tax-free treatment. See R. Willens, "Heller's Acquisition Validates Consensus View on 'Continuity of Interest,'" *Lehman Brothers*, (April 23, 1999).

FIGURE 16.1 Tax-Free Merger under I.R.C. §368(a)(1)(A)—Statutory Merger**Postacquisition Structure:**

Of course, target shareholders will price the attributes of the type of security they receive from the acquirer. For example, target shareholders may demand additional compensation if they receive nonvoting stock of the acquirer. A benefit of this structure is that the acquirer can purchase the target partially for cash while at the same time providing tax-deferred consideration (acquirer stock) to those target shareholders seeking to avoid an immediate taxable gain.

Tax Consequences of a Section 368 "A"

In order to illustrate the tax consequences of the various tax-free acquisition structures, we again use a common set of facts. Table 16.2 contains the quantitative tax effects of various tax-free acquisition structures when applying these facts. Table 16.2 also includes, for reference, the tax effects of a taxable stock acquisition without a Section 338 election using the same input factors.

TABLE 16.2 Comparison of Tax Implications of Tax Free Acquisitions of Freestanding C Corporations**Fact Pattern:**

Purchase price	\$685.00
Target shareholder stock basis	100.00
Net tax basis of target's assets	100.00
$t_c =$	35%
$t_{cg} =$	20%
$r =$	10%

	Tax-Free Acquisitions				Taxable Acquisitions
	\$368 "A"(1)	\$368 "B"(2)	\$368 "C"(3)	\$351(4)	Stock Sale without a \$338 Election
Purchase Price:	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Cash	274.00	0.00	137.00	411.00	685.00
Stock	411.00	685.00	548.00	274.00	0.00
Target corporation tax liability ⁽⁵⁾	0.00	0.00	0.00	0.00	0.00
Target shareholder gain recognized ⁽⁶⁾	274.00	0.00	137.00	411.00	585.00
Target shareholder tax liability ⁽⁷⁾	54.80	0.00	27.40	82.20	117.00
Target Shareholder After-Tax Wealth:					
Cash ⁽⁸⁾	\$219.20	\$0.00	\$109.60	\$328.80	\$568.00
Stock	411.00	685.00	548.00	274.00	0.00
Total	<u>\$630.20</u>	<u>\$685.00</u>	<u>\$657.60</u>	<u>\$602.80</u>	<u>\$568.00</u>
Acquirer Net After-Tax Cost:					
Pretax cost	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Less: incremental tax savings ⁽⁹⁾	0.00	0.00	0.00	0.00	0.00
Net after-tax cost	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>

(1) Assumes that the mix of consideration is 60% stock and 40% cash.

(2) The acquirer purchases the target for 100% stock as required by this structure.

(3) Assumes that the mix of consideration is 80% stock and 20% cash.

(4) Assumes that the mix of consideration is 40% stock and 60% cash.

(5) Tax liability at the target corporation level.

(6) Gain recognized by target shareholders is equal to the lesser of boot received or gain realized.

(7) Tax liability at the target shareholder level. Computed as the lesser of the gain realized or boot received multiplied by the capital gains tax rate.

(8) Cash received in the transaction less tax liability associated with any recognized gains (6).

(9) There are no incremental tax savings because there is no step-up in the tax basis of the target's assets.

The facts in our hypothetical Section 368 "A" transaction are as follows.

- The target, T, has assets with a net tax basis of \$100 (historical cost equals \$100 and no accumulated depreciation).
- T's shareholders have a basis in the stock of T corporation equal to \$100, and they are individuals facing a capital gains tax rate (t_{cg}) equal to 20% (federal and state combined).

- Any acquirer stock received by T's shareholders in the transaction is held until death.⁵
- The acquirer, A, is willing to purchase the target for \$685. The acquirer will use \$274 in cash (40% of the total) and \$411 of acquirer stock (60% of the total).

The shareholders of T will *realize* a gain of \$585 on the acquisition. The realized gain is the difference between the value of consideration received (\$685) and T's shareholder's basis in their T stock (\$100). T's shareholders will recognize a gain of \$274, which is computed as the lesser of the gain realized (\$585) or boot received (\$274). A recognized gain is the taxable gain while a realized gain is not subject to tax until it is subsequently recognized. As a result of the taxable gain of \$274, T's shareholders incur a tax liability of \$54.80 ($\$274 \times 20\%$) and have \$219.20 in cash after-tax and stock worth \$411.

T's shareholders will take a **substituted basis** in the acquiring firm stock received in the transaction. A substituted basis means that the shareholders have the same basis in the A stock as they had in the T stock, plus any gain recognized and minus boot received. In this case, T's shareholders will take a basis in the A stock equal to \$100 plus the gain recognized of \$274 less the boot received of \$274 for a basis of \$100. If T shareholders were to sell this A stock for its fair market value (\$411), they would recognize a capital gain of \$311.⁶ This gain brings the total gain eventually *recognized* on the transaction up to \$585 ($\$274 + \311), which is equal to the gain *realized* on the transaction. The substituted basis computation we demonstrated previously ensures that the realized gain is ultimately recognized in total.

The acquirer will take a carryover basis in the assets of the target. In this case, A will also have a tax basis in the net assets of the target of \$100. The acquirer will not have a basis in the stock of the target because the target was liquidated; that is, the stock of the target was cancelled. The tax attributes of the target will carry over to the acquirer, but they will be limited by **Section 382**. (We present the mechanics of the Section 382 limitations in Section 16.6.) The first column of Table 16.2 presents the particulars of the computations in this section.

Nontax Issues Associated with the Section 368 "A" Structure

Under this structure, the acquirer obtains all the liabilities of the target. As noted in Chapter 14, it is generally preferable for the acquirer to avoid target contingent liabilities if possible. This structure therefore subjects the acquirer to potentially significant nontax costs. In addition, because it is an asset acquisition, some of the target's assets (e.g., licenses, royalty agreements, and governmental permits) may not transfer to the

⁵Throughout these examples, we implicitly assume that all shareholders receive an equal proportion of stock and boot. As a practical matter, target shareholders often have a choice as to whether they want stock or cash in an acquisition but only if the tax structure permits the use of cash. The taxable gain from the acquisition is determined by each shareholder as a function of the consideration received and their basis in the target shares surrendered.

⁶T shareholders' holding period for the A stock is the same as it was for the T stock. That is, the holding period is also substituted.

target. These assets may be nontransferable based on the law or based on the contractual arrangement that created the asset.

An important consideration, from the target shareholders' perspective, relates to the consideration received. When target shareholders receive acquiring firm stock, they are subject to more risk than if they had received cash and used it to purchase a diversified basket of assets. This factor is true of all tax-free structures to the extent target shareholders receive stock of the acquiring firm. In the mid-1990s, in several notable examples, acquiring firms purchased numerous companies with their stock, only to see a subsequent collapse in the price of that stock.⁷ Finally, in some cases, qualifying as a statutory merger can involve significant nontax costs that acquirers and targets may prefer to avoid.

Triangular Mergers

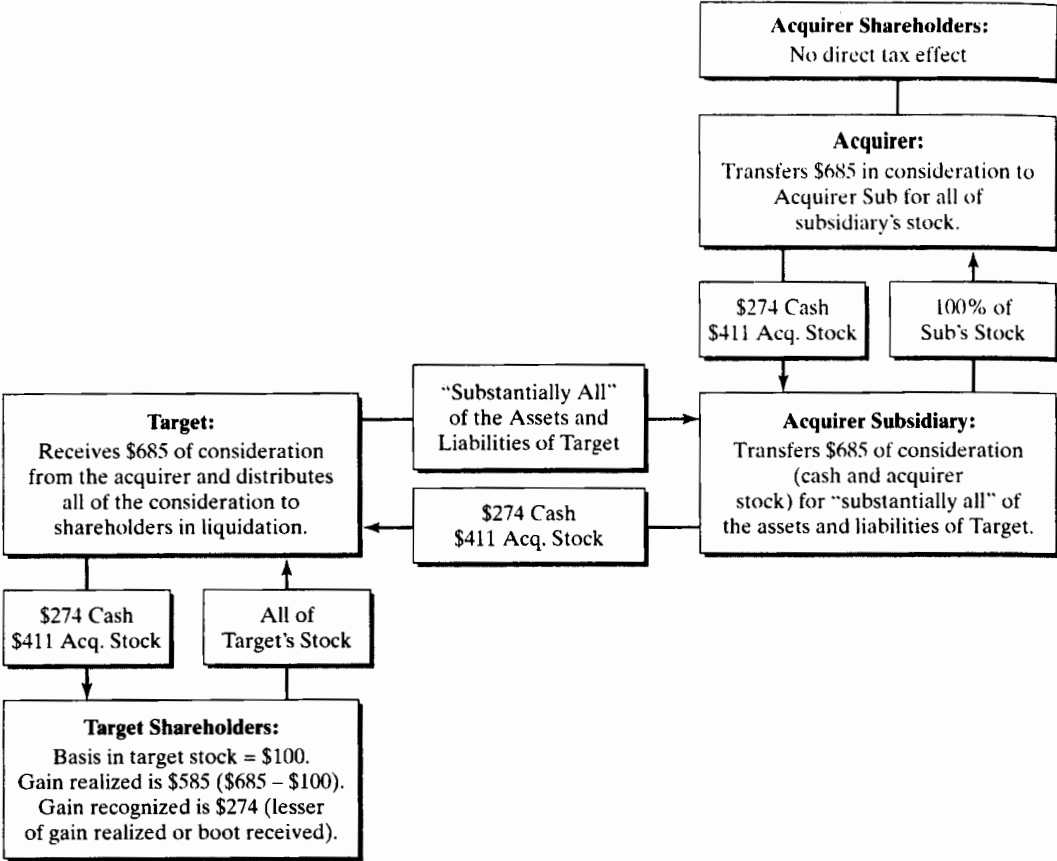
Figure 16.2 illustrates a **forward triangular merger**. Here the acquirer establishes a subsidiary through which it acquires the target. In a forward triangular "A" merger, the acquirer's subsidiary acquires the assets and liabilities of the target in exchange for stock of the acquiring firm. The surviving entity in the merger is the subsidiary of A. As you can see, this structure is similar to the basic A structure, except that A uses a subsidiary to facilitate the acquisition. Another notable difference is that A must acquire substantially all of T's assets, which is defined as 90% of the net fair market value of T's assets and 70% of the gross fair market value of those assets.

This type of structure provides a significant nontax benefit to the acquirer because the target's assets and liabilities, including contingent liabilities, are held in a subsidiary of A. As a result, the acquirer has some protection against contingent and unrecorded liabilities of T through the limited liability accorded to corporate ownership because T's assets and liabilities are held in a subsidiary of A. In addition, because the acquirer uses a subsidiary to complete the merger, acquiring firm shareholders do not have to formally approve a triangular merger. However, if the merger involves the exchange of a substantial amount of acquirer stock, the corporate charter of the acquiring firm may require formal shareholder approval of the deal.

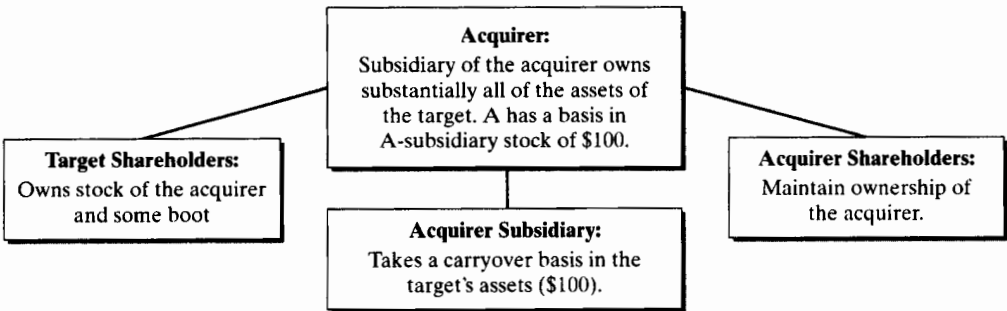
In a **reverse triangular merger**, the surviving entity is the target corporation instead of the acquirer's subsidiary, which is a subsidiary of A after the transaction. This structure is particularly beneficial relative to a forward merger or a basic "A" merger if the target has assets that are difficult to transfer. Additional qualifiers restrict tax-free treatment in reverse triangular mergers, which are beyond the scope of this text. Readers should note, however, that reverse triangular mergers are quite common.

⁷WorldCom's celebrated collapse after its stock-financed acquisition of MCI, the largest merger in U.S. history at the time, is probably the most well known example of this phenomenon. Cendant, Loewen, and McKesson are other acquiring firms whose stock prices plunged after stock-financed acquisitions. See for example "Shares of Former High-Flier Cendant Plunge on Accounting Troubles," *Dow Jones Online News*, (April 16, 1998); D. Morse and M. Heinzl, "Laid Low: Funeral-Home Owners Discover the Downside of Sale to Consolidator: Some Find Payments Cease After Heavy Debt Lands Loewen in Chapter 11," *The Wall Street Journal* (September 17, 1999), p. A1; and G. Ceron, "Accounting Snafu at McKesson HBOC Reminiscent of Cendant Fiasco," *Dow Jones News Service* (April 28, 1999).

FIGURE 16.2 Tax-Free Forward Triangular Merger under I.R.C. §368(a)(1)(A)



Postacquisition Structure:



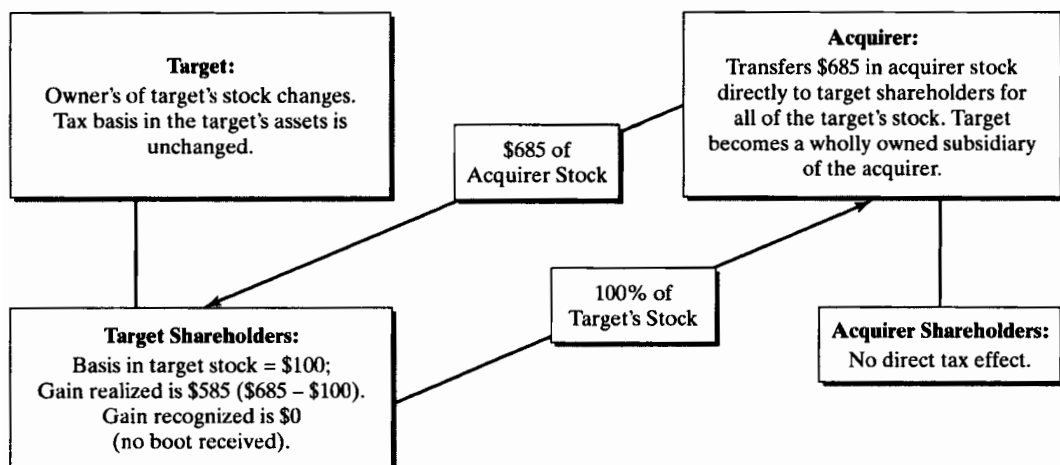
16.3 SECTION 368 "B" REORGANIZATION: STOCK-FOR-STOCK ACQUISITION

The "B" reorganization is a stock acquisition rather than an asset acquisition. The acquirer exchanges its stock directly with that of target shareholders, thereby obtaining ownership of the target's assets through ownership of its stock. Figure 16.3 illustrates a **Section 368 "B" reorganization**. Notice that the target becomes a subsidiary of the acquirer with this structure and therefore maintains its legal identity while the owners of the target's stock change. After the acquisition, this structure looks like a reverse triangular merger under Section 368 "A."

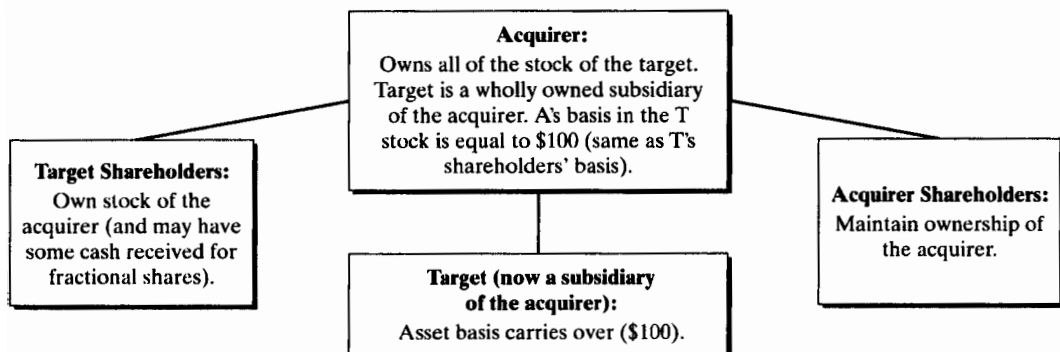
Requirements to Qualify for Tax-Free Treatment under Section 368(a)(1)(B)

As a general rule, this "B" structure is more restrictive than the 368 "A" structure. Unlike an "A" reorganization, a "B" reorganization does not have to be a statutory

FIGURE 16.3 Tax-Free Merger under I.R.C. §368(a)(1)(B)—Stock for Stock Merger



Postacquisition Structure:



merger. Therefore, acquirer and target shareholders need not provide formal approval via proxy vote. However, target shareholders implicitly vote by tendering their shares for acquiring firm shares.

In order for the transaction to qualify for tax-free treatment under Section 368 “B,” 100% of the consideration used in the acquisition must be voting stock of the acquirer. Use of any cash in the transaction disqualifies the deal’s tax-free treatment, with the exception of cash paid for fractional shares. Acquirers can use either common or preferred stock as long as the stock has voting rights. Finally, the acquirer must obtain 80% control of the target in order for the transaction to qualify as tax-free. As a result of this last requirement, transactions of this type are typically unwound prior to formal completion of the deal if the acquirer doesn’t obtain 80% of the target corporation’s stock.

Tax Consequences of a Section 368 “B”

We again use the facts presented in Section 16.2 to illustrate the tax consequences of this structure, with one slight modification related to the percentage of stock received by target shareholders. Under this structure, the acquirer is willing to purchase the target for \$685 (100% of the consideration) of its voting common stock.

The shareholders of T will realize a gain of \$585 on the acquisition. The realized gain is the difference between the value of the consideration received (\$685) and T shareholders’ basis in the T stock (\$100). T’s shareholders will recognize a gain of \$0, which is computed as the lesser of the gain realized (\$585) or boot received (\$0). As a result, T’s shareholders will have stock worth \$685 after tax, and will take a substituted basis in the acquiring firm stock received in the transaction. Thus they will have a basis in the A stock equal to \$100, plus the gain recognized of \$0 less the boot received of \$0 for a basis of \$100. If T shareholders were to sell this A stock for its fair market value (\$685), they would recognize a capital gain of \$585.

The acquirer will again take a carryover basis in the assets of the target. In this case, the acquirer will have a tax basis in the net assets of the target of \$100. Unlike the case in the 368 “A” structure, the acquirer will have a basis in the stock of the target as well. The acquirer takes a carryover basis in the stock of the target equal to the target’s shareholder’s basis in the target’s stock preacquisition, in this case \$100. The second column of Table 16.2 illustrates the computations in this section.

The target corporation becomes a subsidiary of the acquirer and we again encounter a situation in which the acquiring firm could have a different basis in the stock and assets of the target, now a subsidiary of the acquirer.⁸ For example, if the target shareholder’s basis in the stock of the target had been \$200 instead of \$100, then the acquirer would have had basis in the target’s stock and assets of \$200 and \$100, respectively. The tax attributes of the target will carry over to the acquirer, but they will be limited by **Section 382**.

Nontax Issues Associated with the Section 368 “B” Structure

Because the acquirer obtains the stock of the target with this structure, it also is liable for all the target’s liabilities, recorded and unrecorded. This structure therefore subjects the acquirer to potentially significant nontax costs. However, the acquirer’s liability is

⁸Recall in Chapter 14 that taxable stock acquisitions of freestanding C corporations typically result in the acquirer having a basis in the stock of the target that exceeds the net asset basis of the target. See Table 14.2.

limited to its investment in the target because the target is a subsidiary of the acquirer. Unlike the case in a Section 368 “A” merger, the target corporation now becomes a subsidiary of the acquirer. Therefore, the acquirer indirectly obtains all the assets of the target. Title to the target’s assets does not change because the target retains its corporate identity. For this reason, the Section 368 “B” structure can be beneficial if the target has assets that are difficult to transfer. Target shareholders receive stock of the acquirer and are subjected to the same potential costs as mentioned with respect to an “A” structure.

Triangular type structures under 368 “B” are also options, and similar restrictions apply to these structures as noted previously, although the basic restrictions under 368 “B,” such as 100% stock, are typically more onerous than those governing triangular mergers, such as 50% stock minimum.

16.4 SECTION 368 “C” REORGANIZATION: STOCK-FOR-ASSETS ACQUISITION

The “C” reorganization, like the “A” is an asset acquisition rather than a stock acquisition. The acquirer exchanges its voting stock, and perhaps some boot, with the target firm in return for substantially all of the target’s assets. The target then distributes the acquirer’s stock and other consideration received in the acquisition to its shareholders in liquidation. Figure 16.4 illustrates a **Section 368 “C” reorganization**. This structure is similar to the “A” reorganization, with a few notable differences.

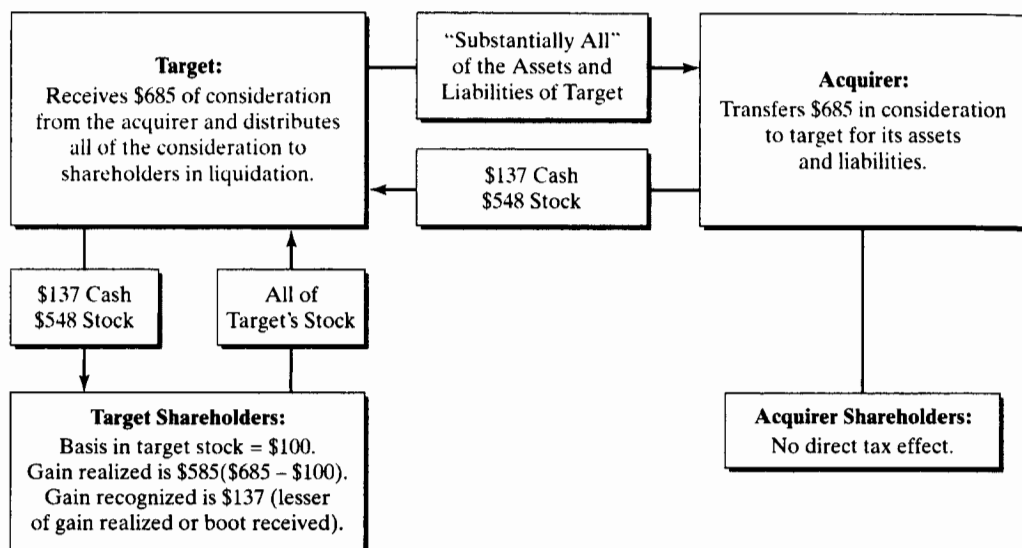
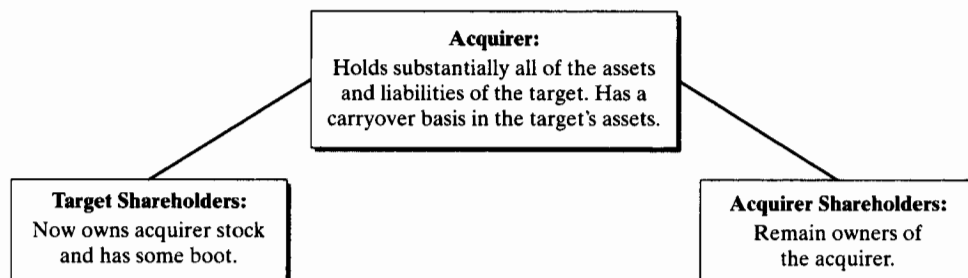
Requirements to Qualify for Tax-Free Treatment under Section 368(a)(1)(C)

This structure is more restrictive on some dimensions than the 368 “A” structure but less restrictive in other respects. Unlike an “A,” a “C” structure does not have to be a statutory merger. However, the acquirer must purchase substantially all the assets of the target in order for the transaction to qualify as tax-free. Substantially all of the target’s assets is defined as 70% of their gross fair market value and 90% of their net fair market value. Unlike the case in the “A” structure, the acquirer is not required to assume all the target’s liabilities. Therefore, it is possible to avoid some of the target’s liabilities while maintaining a tax-free status.

In a “C” reorganization, at least 80% of the total consideration used must be voting stock of the acquiring firm. If the acquirer uses any boot in the transaction, the liabilities of the target assumed by the acquirer count as boot in the 80% test. For example, if an acquirer used 5% cash in a transaction designed to qualify as a “C,” all the target’s liabilities assumed by the acquirer would be treated as if the acquirer had paid cash to satisfy those liabilities in the merger. As a result, all the target’s liabilities are counted as boot in determining whether 80% or more of the consideration received by the target is stock. As a practical matter, this requirement results in “C”-type mergers frequently using 100% stock of the acquirer as consideration.

Tax Consequences of a Section 368 “C”

We use the same facts familiar from the “B” structure now, but we assume that target shareholders receive 20% cash (\$137) and 80% acquiring firm voting stock (\$548 worth). Target shareholders still receive \$685 of total consideration in the merger.

FIGURE 16.4 Tax-Free Merger under I.R.C. § 368(a)(1)(C)—Stock for Asset Acquisition**Postacquisition Structure:**

The shareholders of T will realize a gain of \$585 on the acquisition. The realized gain is the difference between the value of consideration received (\$685) and T's shareholders' basis in the T stock (\$100). T's shareholders will recognize a gain of \$137, which is computed as the lesser of the gain realized (\$585) or boot received (\$137). As a result, T's shareholders will have \$109.60 (the tax liability equals $137 \times 20\%$, or \$27.40) of cash after tax and acquirer stock worth \$548. T's shareholders will take a substituted basis in the acquiring firm stock received in the transaction. With this structure, T's shareholders will take a basis in the A stock equal to \$100 (\$100 substituted basis plus the gain recognized of \$137 less the boot received of \$137). If T's shareholders were to sell the A stock for its fair market value (\$548), they would recognize a capital gain of \$448. Table 16.2 illustrates these computations.

The acquirer will again take a carryover basis in the assets of the target, and will have a tax basis in the net assets of the target of \$100. The stock of the target is not acquired, and therefore, the acquirer does not have a basis in the target's stock. The tax

attributes of the target will carry over to the acquirer, but they will be limited by **Section 382**.

Triangular Section 368 “C” mergers must meet similar requirements as Section 368 “A” triangular mergers. The tax and nontax effects of these triangular Section 368 “C” mergers are nearly identical to those described with respect to triangular Section 368 “A” triangular mergers. The nontax consequences of “C” reorganizations are similar to those described for “A” reorganizations, with the exception of issues relating to statutory mergers.

16.5 TAX-FREE REORGANIZATIONS UNDER SECTION 351

For a variety of reasons, it is often impractical to structure a transaction to qualify as tax-free under the various provision of Section 368. For example, target shareholders may demand more than 60% of the purchase price in cash, making it essentially impossible to qualify an acquisition as tax-free under the continuity of interest principle. It may be the case that the other shareholders of the target demand tax-free treatment and will not participate in a merger that does not provide tax-free treatment. Section 351 has no continuity of interest requirement.

For those deals that cannot qualify as tax-free under Section 368, Section 351 provides a vehicle to achieve tax-free status.⁹ For those readers who are unfamiliar with Section 351, it governs corporate formation transactions. We provide a brief overview of it here to assist with the discussion of Section 351 mergers.

Requirements for Tax-Free Treatment under Section 351

When a new corporation is formed, the founding shareholders generally contribute property, including cash, to the new entity in return for ownership interests (stock). To the extent that shareholders contribute appreciated property, they could be forced to recognize a gain on the exchange of stock for property. Such gain recognition would have undesirable macroeconomic consequences because many viable endeavors would be foregone due to the initial start-up-related tax cost. Section 351 allows the contribution of property to a corporation, tax-free, if certain conditions are met. Specifically, after the contribution, all the contributors must have control of the newly formed entity, which we will call NEWCO. **Control** is defined as ownership of 80% of NEWCO. The contributors can receive NEWCO common or preferred stock and transferors may receive different classes and types of stock.

Contributors who receive stock in NEWCO do so tax-free while those who transfer property to NEWCO in exchange for debt or cash must recognize a taxable gain equal to the lesser of the gain realized on the transfer or the boot received.¹⁰ Contributors who receive stock in NEWCO take a substituted basis in the stock of NEWCO, that is, a basis equal to the basis in the property transferred, which is adjusted for gains recognized and boot received. NEWCO takes a carryover basis in the property transferred increased by any gains recognized by transferring shareholders.

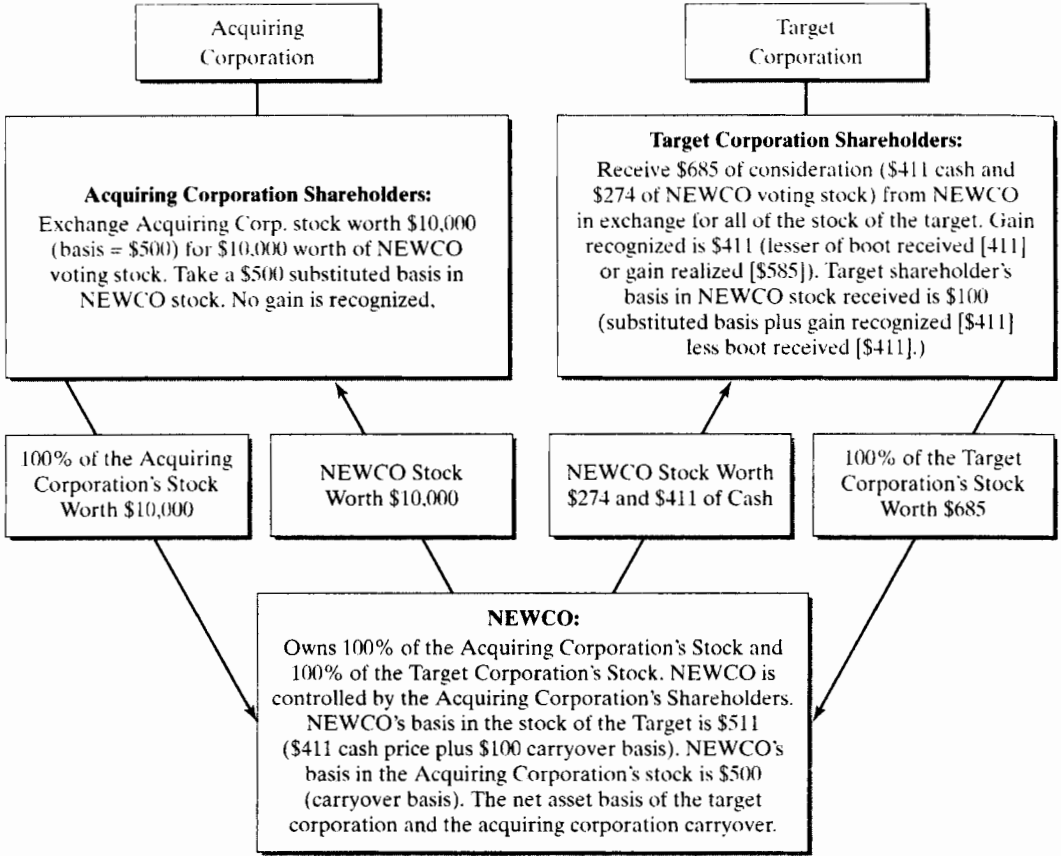
⁹Section 351 may also be used in the creation of a joint venture enterprise.

¹⁰Prior to 1990, debt of NEWCO could be received by the transferor tax-free. Gain recognition was deferred until the transferor received interest and principal payments on the NEWCO debt.

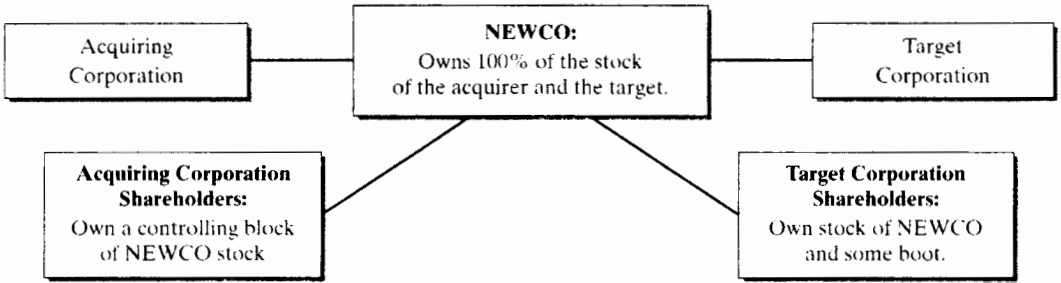
Tax Consequences of a Section 351 Merger

Figure 16.5 provides an illustration of a merger under Section 351. Under this structure, NEWCO is formed by the acquirer. The shareholders of the acquirer (A) contribute their stock in A to NEWCO in return for NEWCO voting stock. A's shareholders have a basis in their A stock of \$500 (fair market value of \$10,000) and A's net asset tax

FIGURE 16.5 I.R.C. §351 Tax-Free Acquisition



Postacquisition Structure:



basis is \$200. A's shareholders will receive NEWCO stock worth \$10,000 in exchange for their A stock. The target (T) corporation's shareholders contribute their T stock to NEWCO in return for NEWCO voting stock.

After the contribution of A and T stock for NEWCO stock, the shareholders of the acquirer and the target control more than 80% of NEWCO. Therefore, the exchange of property (stock) for NEWCO stock is tax-free under Section 351. Under the structure in Figure 16.5, the target and acquirer become wholly owned subsidiaries of NEWCO. As a practical matter, after the Section 351 transaction, NEWCO will likely be restructured using **Section 332**.¹¹ NEWCO will also be renamed, perhaps with a similar name to that of the acquirer.

In order to illustrate the tax consequences of the Section 351 structure, let us once again return to our facts (see Table 16.2). NEWCO is willing to purchase the stock of T for \$685 in total consideration, in other words \$411 of cash and \$274 of NEWCO voting common stock. (Assume that NEWCO borrows the \$411.) Notice that T's shareholders will receive 60% cash and 40% stock of NEWCO.

The shareholders of T will realize a gain of \$585 on the merger. The realized gain is the difference between the value of consideration received (\$685) and T shareholder's basis in the T stock (\$100). T's shareholders will recognize a gain of \$411, which is computed as the lesser of the gain realized (\$585) or boot received (\$411). After tax, they will have stock worth \$274 and cash of \$328.80 (\$411 less tax of \$82.20), and they will take a substituted basis in the NEWCO stock received in the transaction. In this case, T's shareholders take a basis in the NEWCO stock equal to \$100, plus the gain recognized of \$411 less the boot received of \$411 for a basis of \$100.

A's shareholders will realize a gain on the Section 351 transaction equal to \$9,500, but they will not recognize a gain for tax purposes. They will have a substituted basis in the NEWCO stock received equal to \$500.

NEWCO will take a cost basis in the stock of T acquired for cash and a carryover basis in the stock of T acquired for stock. In this case, NEWCO's basis in the T stock acquired will be \$411 (cost basis) plus \$100 (carryover basis) for a total of \$511.¹² If NEWCO sold the stock of T for its fair market value (\$274), a gain of \$174 would be recognized. T becomes a subsidiary of NEWCO and the net asset basis of T carries over and is therefore \$100. The tax attributes of T will likely be limited by Section 382. NEWCO will take a carryover basis in the stock of A (\$500) and a carryover basis in A's net assets (\$200), and A will become a wholly owned subsidiary of NEWCO as a result of the Section 351 exchange.

Although our simple facts readily allow comparison of the basic tax-free acquisition structures, the preceding example doesn't adequately illustrate the potential benefits of a Section 351 merger. Assume that the target has two shareholders (T1 and T2). T1 owns 60% of T and is a tax-exempt institution with a basis in its T stock of \$99. T2 owns 40% of T and is an individual investor with a tax basis in her T stock of \$1. Further, T2 is elderly and had planned to hold her T stock until death at which point her heirs will obtain a step-up in the basis of the stock to fair market value, tax-free.¹³

¹¹Section 332 allows a corporation to liquidate wholly owned subsidiaries in a tax-free manner. Such corporate liquidations are common in various types of acquisitions.

¹²Readers should again notice that the acquirer's (NEWCO's) tax basis of the stock and net assets of the target are different (\$511 and \$100) with this structure.

¹³We are ignoring estate tax consequences in this chapter.

T1 wants to receive cash in the merger, while T2 wants to receive tax-free consideration. The Section 351 structure permits T's shareholders to satisfy their tax preferences when a Section 368 structure likely would not because too much of the consideration is cash due to the continuity of interest rules. This result is one of the primary benefits of the Section 351 structure relative to the more restrictive Section 368 mergers. In this case, T2 is able to defer (avoid) a taxable gain of \$273 (\$274 of consideration, which is 40% of \$685, less a basis of \$1) and a tax liability of \$54.60. Hence, in this scenario, the Section 351 structure generates incremental tax benefits relative to a taxable structure of \$54.60, which increases T2's after-tax wealth by about 25%.

Many other alternatives are available under Section 351. For example, various types of NEWCO stock can be issued to T shareholders. Some T shareholders may prefer stock that pays dividends while others' tax preferences are for zero dividend securities. In general, the forms of consideration paid to T shareholders' can be designed with T's shareholders' tax status and or tax clientele in mind in order to maximize their after-tax wealth and minimize the net after-tax cost to the acquiring firm and NEWCO.

Comparison of Tax-Free Acquisition Structures

In the previous sections, we presented the salient features of basic tax-free acquisition structures. Here we compare and contrast tax and nontax differences across types of **tax-free acquisition structures**.

Nontax Dimensions

Table 16.1 compares and contrasts differences in the tax and nontax implications of various tax-free acquisition structures discussed in this chapter. Understanding these differences is paramount to being an effective tax planner. In particular, it is important to understand the requirements of the different tax-free transactions in order to anticipate opportunities and constraints associated with a sale or acquisition. When then is each of these structures most beneficial, ignoring pricing issues? Readers can use Table 16.1 to identify which acquisition tax structure is functional given the nontax constraints present in the transaction.

The Section 368 "A" structure provides a great degree of flexibility in terms of the types of consideration that can be offered while maintaining tax-free treatment. This structure may be particularly preferable when the acquirer is sensitive to dilution of voting control because target shareholders can be given nonvoting stock without disqualifying the transaction's tax-free status.

A primary benefit of the Section 368 "B" structure is that it avoids the complexities associated with qualifying the transaction as a statutory merger. It also provides a degree of liability protection because the target becomes a subsidiary of the acquirer. One of the most significant benefits of a "B" reorganization is that it allows the acquirer to obtain all the target's assets, even those that are not transferable to another entity.

The Section 368 "C" structure can be used when the transaction cannot meet the requirements of a "B" reorganization and is similarly unable to qualify as a statutory merger as required for a valid "A" reorganization. A Section 351 structure allows target shareholders to receive tax-free consideration when Section 368 transactions would not.

Tax Dimensions

As Table 16.2 illustrated, the tax-free acquisition structures discussed in Sections 16.2 through 16.5 have differing wealth effects for target shareholders.¹⁴ Notice that the net after-tax cost of the acquisition to the acquirer is \$685 in each of our examples. Target shareholders should prefer the Section 368 “B” transaction because their after-tax wealth is highest with this alternative when considering only tax consequences.

However, target shareholders may be indifferent between the Section 368 “B” and “A” structures if they are sufficiently averse to holding acquirer stock. That is, target shareholders may demand a premium for receiving relatively more acquirer stock because acquirer stock is riskier than cash. In particular, cash can be invested in a diversified portfolio of assets while acquirer stock cannot, absent significant transaction costs¹⁵. We return to a comparison of the tax consequences of tax-free, and taxable, acquisition structures under more realistic assumptions in Section 16.7.

16.6 LIMITATIONS ON TARGET FIRM TAX ATTRIBUTES

After 1986, any transaction that results in a 50% change in ownership of a corporation triggers a limitation on the firm’s net operating losses under Section 382.¹⁶ Other limitations apply to the use of other target firm tax attributes, such as capital loss carryforwards and excess tax credits, as specified in Sections 381, 383, and 384. We focus on the limitations on a target’s net operating losses as defined under Section 382.¹⁷ The Section 382 limitation is computed as a function of the market value of the subject firm’s stock at the time of the ownership change and the **long-term tax-exempt rate**. Specifically, an annual limitation on the amount of the subject firm’s tax attributes, such as NOLs, that can be used is computed as the market value of the subject firm’s equity at the date of the ownership change multiplied by the long-term tax-exempt rate of return.¹⁸ The long-term tax-exempt rate of return is defined and reported periodically by the U.S. government.

Consider a target firm with NOLs of \$100 that is purchased for \$200 in a taxable stock acquisition without a Section 338 election, when the long-term tax-exempt rate is 5%. Each year postacquisition, the acquiring firm can use \$10 (5% multiplied by \$200 equity value at the time of the ownership change) of T’s NOLs to offset taxable income.

¹⁴The differential wealth effects are a function of the portion of consideration received by target shareholders that is acquirer stock. If target shareholders received 100% acquirer stock across transaction tax structure, their wealth would be identical.

¹⁵For example, target shareholders could borrow against acquirer shares and use the loan proceeds to purchase a diversified basket of securities. The transactions cost of such a strategy may be high.

¹⁶The definition of a qualifying ownership change is quite complex. It is sufficient for readers to understand that in essentially any acquisition, taxable or tax-free, an ownership change as defined under Section 382 occurs.

¹⁷Section 381 provides the general rules regarding the postacquisition use of target tax attributes in carryover basis transactions while Section 382 deals primarily with limitations on acquirer use of target preacquisition NOLs. Section 383 controls limitations on capital loss carryforwards and target preacquisition tax credits. Section 384 provides restrictions on the use of the acquirer’s losses to offset built-in gains of the target.

¹⁸Prior to the Tax Reform Act of 1986, the limitation on a target’s NOLs differed across carryover basis taxable and tax-free transactions. Since 1986, the limitations on a target’s tax attributes are essentially identical in taxable and tax-free transactions.

If the combined entity had \$20 of income in the year following the acquisition, only \$10 of the income could be offset by the NOL. If the combined entity has \$5 of taxable income in a particular year postacquisition, the \$5 of unused NOL for that year can be carried forward to the following year. The same limitations apply to capital losses, tax credits, and so-called built-in losses.¹⁹ To the extent that a target firm—a subsidiary of the acquirer postacquisition—generates losses *postacquisition*, however, these losses can be offset by profits of the acquirer without limitation.

As noted in Chapter 14, in taxable transactions in which the tax basis of the target's assets are stepped-up, the target firm's NOLs can be used to offset the corporate-level gain on the actual or deemed asset sale. For this reason, it is most common to see transactions structured to result in a step-up of a freestanding C corporation's assets when the target has large NOLs. However, any of the target's NOLs and other valuable tax attributes that are not used to offset the gain on the step-up are lost. Therefore, the decision to step-up the tax basis of the target's assets, which results in the loss of the target's NOLs, is optimal only if the loss of tax savings from the target's tax attributes does not exceed the net tax benefits of the step-up.

How does the acquirer determine whether to structure the acquisition to preserve the target's NOLs? Table 16.3 presents an analysis of the tax costs and benefits of preserving a target's NOLs in a carryover basis transaction relative to using the NOLs to offset the gain on a step-up in the target's assets. In this table, we compare a taxable stock acquisition of a freestanding C corporation in which no Section 338 election is made to a taxable stock acquisition in which the Section 338 election is made. We choose to compare two taxable acquisition structures rather than a taxable and tax-free acquisition in order to avoid the differences in shareholder tax effects.²⁰ Returning to our example, notice that target shareholders are indifferent between the two structures, both with \$648 after tax, and therefore the structuring choice turns on target corporation NOL-related tax effects.

Given the facts in Table 16.3, the target corporation has NOLs of \$450, the net basis in the target's assets is \$100, and the price that an acquirer is willing to pay for the stock of the target is \$685. The corporate tax rate is 35%, the shareholder capital gains tax rate is 20%, and the after-tax discount rate is 10%. We assume that any step-up in the tax basis of the target's assets is amortized over 10 years on a straight-line basis. We also assume that the appropriate long-term tax-exempt rate applicable to target NOLs under Section 382 is 5% and that the target's NOLs expire in exactly 20 years.

Under these assumptions, the aggregate deemed sale price (*ADSP*) in a Section 338 transaction is \$757.69, and the target corporate-level gain is \$657.69 (\$757.69 *ADSP* less \$100 target asset basis).²¹ The target's NOLs can be used to offset \$450 of the \$657.69 gain on the step-up. The target corporation (now a subsidiary of the acquirer)

¹⁹A built-in loss occurs when the target corporation has assets with a tax basis greater than fair market value at the time of the acquisition. If the acquirer sells these assets postacquisition, it is realizing tax losses that were derived from the preacquisition target. Hence, these losses are also limited.

²⁰A similar analysis could be performed comparing a tax-free carryover basis transaction with a taxable acquisition that resulted in a step-up in the target's assets. We leave such an analysis as an exercise for readers.

²¹The *ADSP* computation (previously discussed in Chapter 14) when the target had NOLs can be represented in general as:

$$ADSP = P + L + t_c(ADSP - \text{BASIS} - \text{NOL})$$

The NOL variable in the equation cannot be larger than *P* less Basis, however.

TABLE 16.3 Comparison of Tax Effects on Target Tax Attributes of Various Acquisition Structures

Fact Pattern:

Purchase price	\$685.00	
Target shareholder's stock basis	500.00	
Net tax basis in the target's assets	100.00	
ADSP ⁽¹⁾	757.69	
Pre-acquisition target NOLs	450.00	
$t_c =$	35%	
$t_{cg} =$	20%	
$r =$	10%	
Long-term tax-exempt rate =	5%	
Amortization period (n) =	10	
	Taxable Stock Acquisition with a §338 Election	Taxable Stock Acquisition without a §338 Election
Target Shareholder Effects:		
Cash received	\$685.00	\$685.00
Tax on stock sale ⁽²⁾	37.00	37.00
After-tax cash ⁽³⁾	<u>\$648.00</u>	<u>\$648.00</u>
Target Corporation Tax Effects:		
Gain on step-up ⁽⁴⁾	\$657.69	\$0.00
Less: NOLs	450.00	n/a
Taxable gain on step-up ⁽⁵⁾	<u>\$207.69</u>	<u>n/a</u>
Tax on gain ⁽⁶⁾	\$72.69	n/a
Tax Benefits:		
<i>From Carryover of NOLs:</i>		
Gross NOL carryovers	\$0.00	\$450.00
Annual limitation ⁽⁷⁾	0.00	34.25
Annual tax savings ⁽⁸⁾	0.00	11.99
Present value of tax savings ⁽⁹⁾	0.00	85.59
<i>From a Step-up in Target's Assets:</i>		
Gross step-up ⁽¹⁰⁾	\$657.69	n/a
Annual deduction ⁽¹¹⁾	65.77	n/a
Annual tax savings ⁽¹²⁾	23.02	n/a
Present value of tax savings ⁽¹³⁾	141.44	n/a
<i>Computation of Net Tax Benefits:</i>		
Gross tax benefits (9) & (12)	\$141.44	\$85.59
Incremental tax cost ⁽⁶⁾	72.69	0.00
Net tax benefits ⁽¹⁴⁾	<u>\$68.75</u>	<u>\$85.59</u>

⁽¹⁾ADSP is computed as $G + L + t_c(ADSP - \text{Basis} - \text{NOL})$. In this case, $G = \$685$, $L = \$0$, Basis = \$100, NOL = \$450 and $t_c = 35\%$. ⁽²⁾Tax on stock sale is equal to the gain (\$685 less \$500 stock basis) multiplied by the capital gains tax rate. ⁽³⁾Purchase price less tax. Notice that target shareholder's are indifferent between these two structures as their after-tax cash is identical. The structure decision therefore turns on the incremental corporate tax effects on the target corporation. ⁽⁴⁾Gain on the step-up is computed as ADSP less the net tax basis in the target's assets. This amount is zero when the §338 election is not made. ⁽⁵⁾Taxable gain on step-up is the gain on step-up less the NOL. NOLs reduce the gain dollar for dollar. ⁽⁶⁾Tax on the gain is the corporate tax rate multiplied by the taxable gain (5). ⁽⁷⁾The annual amount of the target's NOLs available to offset taxable income of the target as defined by I.R.C. §382. Computed as the total value of the target's stock at the date of acquisition (\$685) multiplied by the long term tax-exempt rate of return (5%). ⁽⁸⁾The annual limitation (7) multiplied by the corporate tax rate. ⁽⁹⁾The present value of reducing the combined firm's tax liability by \$11.99 for 13.1 years discounted at the after-tax discount rate (10%). ⁽¹⁰⁾The gross step-up is equal to the difference between ADSP and the net tax basis of the target's assets preacquisition. ⁽¹¹⁾The gross step-up (\$657.69) divided by the estimated amortization period (10 years) for the step-up. ⁽¹²⁾(11) multiplied by the corporate tax rate. ⁽¹³⁾The present value of depreciation deductions from the step-up discounted at the after-tax discount rate of 10%. ⁽¹⁴⁾Net tax benefits are the gross tax benefits resulting from stepping up the target's assets less the incremental cost of doing so and tax benefits from preserving the target's NOLs, respectively.

will therefore face a tax liability of \$72.69 on the gain on step-up. The step-up in the target's assets is \$657.69 and under our assumptions, the step-up will generate \$65.77 (\$657.69/10 years) of additional depreciation deductions each year. The present value of the tax deductions from the step-up under the preceding assumptions is \$141.44. The tax cost of obtaining the step-up is \$72.69 (\$207.69 taxable gain after NOL utilization multiplied by 35%), so the net tax benefit from the step-up is \$68.75 (\$141.44 incremental tax benefit less \$72.69 incremental tax cost).

If the Section 338 election is not made, the NOLs of the target carry over. The annual limitation on the target's NOLs under our scenario is \$34.25 and is computed as the long-term tax-exempt rate (5%) multiplied by the purchase price of the target's equity (\$685). The target's NOLs then will generate \$11.99 (\$34.25 multiplied by the tax rate of 35%) worth of tax savings a year for approximately 13.1 years (\$450 of NOLs divided by \$34.25 per year).²² The present value of the tax savings from these NOLs is \$85.59 (discounted again at a 10% after-tax rate).

In the example presented here, it would be optimal not to make the Section 338 election because the net benefit under the Section 338 structure is \$68.75, while the net tax benefit of preserving the target's NOLs is \$85.59. However, it is a close call. The estimates in Table 16.3 are sensitive to the useful life applied to any step-up in the target's assets and the number of years remaining before the target's NOLs expire. As the useful life of the target's assets increases, the present value of additional depreciation-related tax deductions declines. Similarly, as the remaining carryforward years for the target's NOLs declines, the present value of preserving those tax attributes also declines because some of the NOLs will expire unused.

In any event, the computations in Table 16.3 provide a basic financial model to compare the tax implications for a target's tax attributes of various acquisition structures. Additional complexity can obviously be added.

Limitations on Acquiring Firm Tax Attributes

The change of ownership rules of Section 382 can also affect the tax attributes of an acquirer in a stock-financed acquisition. A large stock issue by the acquirer has the potential to trigger the 50% ownership change rule under Section 382 and therefore an acquirer needs likewise to consider the impact of the structure of an acquisition on its tax attributes.

Consider WorldCom's 1997 acquisition of MCI, which was a stock-financed acquisition. Because MCI's market value preacquisition was approximately the same as WorldCom's value, a Section 382 ownership change was likely to occur as a result of that transaction. WorldCom had more than \$1 billion of NOLs prior to the MCI acquisition, so the limitations under Section 382 were potentially onerous.²³

Taking Advantage of Expiring NOLs: Sale/Leaseback

Assume that a profitable acquirer recently acquired a target firm that has \$100 million of NOLs due to expire within the next 2 years. Further assume that these \$100 million

²²It is possible that the target's NOLs may expire in less than 13 years. In such a scenario, the estimation must be modified accordingly.

²³As a practical matter, most of WorldCom's NOLs were already restricted due to Section 382. That is, WorldCom's NOLs were primarily derived from previously acquired targets and hence these NOLs were already limited due to the previous acquisition. See the tax footnote from WorldCom's 1997 10-K.

of NOLs are subject to a Section 382 limitation of \$10 million per year. Can the acquirer construct a strategy that prevents the valuable NOLs from expiring unused?

In one option, NOLs that are limited by Section 382 can be used by the acquirer to offset gains triggered from the sale of assets that had a **built-in gain** at the time of the acquisition. That is, if this target had assets with a basis of \$1 million and a fair market value of \$76 million at the time of the acquisition, it had a built-in gain of \$75 million.²⁴ If the acquirer, who now owns the target, were to sell the built-in gain assets, the gain on the sale would be shielded by the expiring NOLs. Specifically, if these assets were sold for \$76 million, a corporate level gain of \$75 million would be recognized, but \$75 million of the acquired target's NOLs would offset this gain, leaving the taxable gain on the sale at \$0.

Although the gain on this sale doesn't trigger a tax, the selling firm now may be without productive assets that it needs. In addition, the selling firm was seeking a strategy that would utilize the acquired target's NOLs as a tax shield for the firm's taxable income. The sale doesn't really accomplish this objective.

The acquirer in our example can meet this latter objective with one additional modification in the sale strategy. It can sell the built-in gain assets to a financial firm and then lease them back. In this way, the acquirer can maintain use (and perhaps effective ownership) of the built-in gain assets while at the same time generating a recurring tax deduction from the lease payments and perhaps depreciation deductions on the assets. Essentially what this strategy does is convert the expiring NOLs into rental and/or depreciation deductions, which are not limited by Section 382.

16.7 QUANTIFYING PRICING DIFFERENCES BETWEEN TAXABLE AND TAX-FREE ACQUISITIONS OF FREESTANDING C CORPORATIONS

As we have emphasized throughout this text, it is critical to consider the tax implications of a contract to both (or all) parties. In this chapter and in Chapter 14, we have introduced the major tax implications of various structures for buying and selling free-standing C corporations. But how do a buyer and seller arrive at a decision regarding the tax structure and pricing for a transaction? In this section, we illustrate the effect of the tax status and preferences of the acquirer, the target corporation, and the target's shareholders on a transaction's structure (taxable or tax-free) and price.

Table 16.4 presents a financial model from which the analysis follows. We make a number of assumptions for purposes of this illustration:

- Tax basis of the target's net assets = \$100
- Target shareholder stock basis = \$10
- t_c (corporate tax rate) = 35%
- t_{cg} (shareholder capital gains rate) = 20%
- r (after-tax discount rate) = 10%
- Value of the target's stock = \$685

²⁴Readers may wonder why the acquirer didn't step up the tax basis of the target's assets in the acquisition when there was such a large built-in gain and potential for increased depreciation benefits. Recall from Chapter 14 that a step-up would not typically be viable when the target was a freestanding C corporation. In this scenario, the built-in gain assets could be a small fraction of the target's total assets.

TABLE 16.4 Comparison of Tax Implications of Tax-Free Acquisitions of Freestanding C Corporations**Fact Pattern:**

Purchase price	\$685.00
Target shareholder stock basis	10.00
Net tax basis of target's assets	100.00
$t_c =$	35%
$t_{cg} =$	20%
$r =$	10%

	Tax-Free Acquisition Structures				Taxable Structure
	\$368 "A"(1)	\$368 "B"(2)	\$368 "C"(3)	\$351(4)	Stock Sale without a \$338 Election
Purchase Price:	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Cash	274.00	0.00	137.00	411.00	685.00
Stock	411.00	685.00	548.00	274.00	0.00
Target corporation tax liability(5)	0.00	0.00	0.00	0.00	0.00
Target shareholder gain recognized(6)	274.00	0.00	137.00	411.00	685.00
Target shareholder tax liability(7)	54.80	0.00	27.40	82.20	135.00
Target Shareholder After-Tax Wealth:					
Cash(8)	\$219.20	\$0.00	\$109.60	\$328.80	\$550.00
Stock(9)	411.00	685.00	548.00	274.00	0.00
Total	<u>\$630.20</u>	<u>\$685.00</u>	<u>\$657.60</u>	<u>\$602.80</u>	<u>\$550.00</u>
Acquirer Net After-Tax Cost:					
Pretax cost	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Less: incremental tax savings	0.00	0.00	0.00	0.00	0.00
Net after-tax cost	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>
Pretax price to leave target shareholders indifferent(10)	<u>\$597.83</u>	<u>\$550.00</u>	<u>\$572.92</u>	<u>\$625.00</u>	<u>\$685.00</u>

(1) Assumes that the mix of consideration is 60% stock and 40% cash.

(2) The acquirer purchases the target for 100% stock as required by this structure.

(3) Assumes that the mix of consideration is 80% stock and 20% cash.

(4) Assumes that the mix of consideration is 40% stock and 60% cash.

(5) Tax liability at the target corporation level.

(6) Gain recognized by target shareholders is equal to the lesser of boot received or gain realized.

(7) Tax liability at the target shareholder level. Computed as the lesser of the gain realized or boot received multiplied by the capital gains tax rate.

(8) Cash received in the transaction less tax liability associated with any recognized gains.

(9) Assumes that target shareholders hold acquirer stock until death.

(10) The pretax price that leaves target shareholders with the same after-tax wealth as a taxable stock acquisition at a price of \$685.

- Target shareholder holds acquirer stock received in the merger until death.
- The target corporation is a C corporation.
- The target is owned by individual investors.
- The target corporation has no liabilities.
- The acquirer's stock does not pay dividends, and the acquirer does not intend to pay dividends anytime in the future.

The acquiring firm is a C corporation, and it is considering purchasing the target using one of the following acquisition structures.²⁵

- Taxable stock acquisition without a Section 338 election (100% cash)²⁶
- Tax-free asset acquisition under Section 368 "A" (40% cash, 60% stock)
- Tax-free stock acquisition under Section 368 "B" (100% stock)
- Tax-free asset acquisition under Section 368 "C" (20% cash, 80% stock)
- Tax-free stock acquisition under Section 351 (60% cash, 40% stock)

Table 16.4 compares and contrasts the tax implications of each of these structures on the target's shareholders, the target corporation, and the acquirer. Notice that the purchase price for all the structures is \$685, and that the purchase price selected leaves the acquirer's after-tax cost equivalent across transaction structures (\$685). In all the tax-free acquisitions, we assume that target shareholders hold the acquiring firm stock received in the merger until death so target shareholders never face a tax liability on the transaction to the extent of acquirer stock received. We later relax this assumption in Table 16.5.

The first four columns of Table 16.4 present the tax implications of various tax-free structures. At a pretax price of \$685, target shareholders after-tax wealth is highest under the Section 368 "B" structure because target shareholders incur no current tax liabilities with this structure. All the tax-free structures leave the target's shareholders relatively better off than the taxable transaction structure because of the deferral (avoidance under our assumptions) of the capital gains taxes associated with the sale of target shares in a taxable transaction.

In the lower portion of Table 16.4, we compute the pretax acquisition price that leaves the target corporation's shareholders indifferent between a taxable stock acquisition at \$685 and a tax-free structure at the determined price. As we did in Chapter 14, we can formally define the prices at which an acquirer and seller are indifferent across transaction tax structures. Such an analysis allows us to enumerate with some precision the optimal structure for an acquisition.²⁷ We specify target shareholders' indifference

²⁵In this text, we focus on the differential tax consequences of various acquisition structures. As a practical matter, the tax structure for an acquisition may be determined in part by the attitude of an acquisition (friendly vs. hostile). The less friendly the transaction, the more likely that at least some cash will be used to acquire control of the target. The analyses here provide a technique to quantify the wealth effects associated with mixed consideration (stock and cash) acquisitions.

²⁶We omit taxable acquisitions that result in a step-up in the target's assets from this analysis because those structures are quite rare for the reasons illustrated in Chapter 14.

²⁷It is important for readers to note that the subsequent analysis ignores target shareholder tax attributes (capital loss carryforwards), target corporation tax attributes (such as NOLs and capital loss carryforwards), and that we assume that all involved parties face the maximum individual or corporate tax rate. After working through the logic, readers should be convinced that such complications could be added quite easily. We omit them here for ease of illustration.

TABLE 16.5 Comparison of Tax Implications of Tax-Free Acquisitions of Freestanding Companies: Advanced Example**Fact Pattern:**

Purchase price	\$685.00	Estimated holding period for	
Net tax basis of target's assets	100.00	acquiring firm stock	
Target shareholder's basis in target stock =	10.00	obtained in the merger =	2 years
t_c =	35%	Estimated pretax appreciation	
t_{cg} =	20%	in acquirer stock	
r =	10.114%	postacquisition	12.500%

	Tax-Free Acquisition Structures				Taxable Structure
	\$368 "A"(1)	\$368 "B"(2)	\$368 "C"(3)	\$351(4)	Stock Sale without a §338 Election
Purchase Price:	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Cash	274.00	0.00	137.00	411.00	685.00
Stock	411.00	685.00	548.00	274.00	0.00
Target corporation tax liability ⁽⁵⁾	0.00	0.00	0.00	0.00	0.00
Target shareholder gain recognized at date of acquisition ⁽⁶⁾	274.00	0.00	137.00	411.00	675.00
Target shareholder tax liability at date of acquisition ⁽⁷⁾	54.80	0.00	27.40	82.20	135.00
Target Shareholder After-Tax Wealth (Assuming 2-Year Holding Period for the Acquiring Firm's Stock):					
Cash ⁽⁸⁾	\$219.20	\$0.00	\$109.60	\$328.80	\$550.00
Stock ⁽⁹⁾	344.85	573.66	459.25	230.45	0.00
Total	<u>\$564.05</u>	<u>\$573.66</u>	<u>\$568.85</u>	<u>\$559.25</u>	<u>\$550.00</u>
Acquirer Net After-Tax Cost:					
Pretax cost	\$685.00	\$685.00	\$685.00	\$685.00	\$685.00
Incremental tax savings	0.00	0.00	0.00	0.00	0.00
Net after-tax cost	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>	<u>\$685.00</u>
Pretax price to leave target shareholders indifferent ⁽¹⁰⁾	<u>\$667.89</u>	<u>\$656.67</u>	<u>\$662.23</u>	<u>\$673.64</u>	<u>\$685.00</u>

(1) Assumes that the mix of consideration is 60% stock and 40% cash.

(2) The acquirer purchases the target for 100% stock as required by this structure.

(3) Assumes that the mix of consideration is 80% stock and 20% cash.

(4) Assumes that the mix of consideration is 40% stock and 60% cash.

(5) Tax liability at the target corporation level.

(6) Computed as the lesser of the gain realized or boot received.

(7) Tax liability at the target shareholder level multiplied by the capital gains tax rate.

(8) Cash received in the transaction less tax liability associated with any recognized gains.

(9) Assumes that target shareholders hold acquirer stock for two years and then sell. Computation also assumes that the acquirer stock appreciates at the pretax rate of return of 12.5% from the date of the acquisition until the date of the final sale. The taxable gain on the sale is computed as the value of the acquirer's stock two years from the acquisition less the basis in that stock. The after-tax proceeds from the stock sale are discounted using the after-tax rate of return (10.114%).

(10) The pretax price that leaves target shareholders with the same after-tax wealth as a taxable stock acquisition, with no §338 election, at a price of \$685.

price in a tax-free acquisition as the right-hand side of equation (16.1), given their after-tax wealth in a taxable stock acquisition:²⁸

$$\begin{aligned}
 ATAX_{\text{taxablestock}} &= \text{Price}_{\text{tax-free}} - \text{Tax} \\
 ATAX_{\text{taxablestock}} &= \{[\text{Price}_{\text{stock}}\%(1+R)^n] - [(\text{Price}_{\text{stock}}\%(1+R)^n - \text{Stock})t_{\text{cg}}]\} / \\
 &\quad (1+r)^n + \text{Price}_{\text{boot}}\% - \text{Price}_{\text{boot}}\%t_{\text{cg}} \\
 ATAX_{\text{taxablestock}} &= \{[\text{Price}_{\text{stock}}\%(1+R)^n] - [\text{Price}_{\text{stock}}\%(1+R)^n - \text{Stock}]t_{\text{cg}}\} / \\
 &\quad (1+r)^n + \text{Price}_{\text{boot}}\%(1-t_{\text{cg}}) \tag{16.1}
 \end{aligned}$$

where

$ATAX_{\text{taxablestock}}$ = target shareholders' after-tax wealth in a taxable stock transaction

$\text{Price}_{\text{tax-free}}$ = the total pretax consideration received by target shareholders in a tax-free transaction

$\text{Price}_{\text{stock}}\%$ = the value of consideration paid to target shareholders in stock

$\text{Price}_{\text{boot}}\%$ = the value of consideration paid to target shareholders that is boot (cash or debt securities)

Stock = target shareholder's basis in the stock of the target

R = the *pretax* rate of return on the acquirer's stock

r = the *after-tax* rate of return

t_{cg} = the shareholder capital gains tax rate

n = the holding period for the acquirer stock

The first term on the right-hand side of equation (16.1) is the future value of the acquirer's stock received in the acquisition n periods in the future. The second term is the value of the tax incurred by target shareholders when they sell the acquirer stock received in the acquisition, n periods in the future. The difference between these two terms is discounted to present value. The last term in equation (16.1) produces the after-tax wealth of target shareholders associated with boot received at the date of the acquisition.²⁹ If target shareholders intend to hold acquirer stock until death, the second term in the equation becomes zero.³⁰ Similarly, if no boot is used in the acquisition, the third term is zero. We assume that target shareholders invest any after-tax cash (boot) in securities that earn the same pretax return (R) as yielded by the acquirer's stock.

For a Section 368 "A" structure, the pretax price that leaves target shareholders indifferent is approximately \$597.83 while a 100% stock deal under Section 368 "B" could be priced at \$550 and target shareholders would be indifferent after tax relative to a taxable stock acquisition at \$685. At those pretax prices, target shareholders have the same after-tax wealth as they have under the taxable structure (\$550). For example, at \$597.83 under the Section 368 "A" structure, target shareholders receive \$239.13 of cash and \$358.70 of stock (40% cash, 60% stock). Target shareholders again

²⁸The left-hand side of equation (16.1) is defined by equation (14.4) in Chapter 14.

²⁹In deriving equation (16.1) we explicitly assumed that the gain realized would exceed boot received. That is, we assume that the all boot received is immediately taxable. This assumption could be relaxed of course, but equation (16.1) would become less tractable.

³⁰We are ignoring any estate tax-related costs and the interaction between income taxes and estate taxes.

face taxable gains equal to the lesser of the gain realized or the boot received. The gain realized is \$497.83, which is computed as the difference between the value of consideration received (\$597.83) and shareholder basis in the target's stock (\$100). Boot received is \$239.13, so the gain recognized is \$239.13. Capital gains taxes for individual investors are 20%, and the capital gains tax liability on this transaction would therefore be \$47.83, or $239.13 \times 20\%$. Target shareholders would then have \$358.70 of acquirer stock and \$191.30 of cash after tax for total wealth of \$550.

Would the acquirer rather pay \$685 (cash) in a taxable stock acquisition or \$550 (in stock) in a tax-free stock transaction? Ignoring nontax considerations, the acquirer would obviously prefer to pay less and would therefore prefer the Section 368 "B" structure at \$550. If the acquirer pays the target \$551 of its stock in a Section 368 "B" transaction, it is better off by \$134, or $685 - 551$, relative to the taxable stock deal priced at \$685. This point is profound, and one that we have seen several times throughout this text. Why can the acquirer pay 19.7% less *pretax*, or $(685 - 550)/685$, when using a different tax structure? Because the seller receives consideration that is tax-favored (deferred taxation). The seller will take less of this tax-favored consideration because it is equally well or better off after tax than when it receives a tax-disfavored consideration.³¹

Essentially this conclusion reduces to the fact that considering the tax preferences and attributes of all contracting parties can result in structures that are beneficial to both parties. From a seller's (target shareholder) perspective, a price of \$685 in a Section 368 "B" transaction leaves the acquirer's net after-tax cost the same as the taxable stock acquisition without a Section 338 election. So a seller could offer to take \$684 (or less) in acquirer stock, thereby leaving the acquirer better off after tax than under the taxable acquisition structure, while the target's shareholders are better off by \$134.

The bottom line then is that, with clever tax planning, an acquirer might be able to purchase a target firm for less or a seller may be able to sell it for relatively more. "Clever tax planning" is defined here as considering the tax preferences of one's counterparty and exploiting those preferences.

Our simple illustration ignores some important nontax consequences of these alternate structures that influence transaction structures and prices. Tax-free transactions require the use of acquirer stock, typically a great quantity of acquirer stock. Such a large stock issue dilutes the control of existing acquiring firm shareholders, particularly manager shareholders. As a result, the acquiring firm may prefer, for nontax reasons, not to issue its stock to target shareholders. Furthermore, if the acquirer uses stock, earnings-per-share consequences will be associated with the acquisition. If the earnings-per-share consequences of a stock deal are more adverse than a cash deal, the acquirer may choose not to pay for the target with its stock.³²

Finally, acquirer stock fluctuates in value, unlike cash, and it therefore subjects target shareholders to additional risk beyond what they would face if they received cash. Target shareholders may thus prefer to receive cash rather than stock when the purchase price is the same. On the other hand, acquirers may prefer to use stock when

³¹Ignoring the nontax costs of receiving acquiring firm stock.

³²This factor can be analyzed, quite precisely, using a financial model like the one in Table 16.4. See for example, "Modeling the effects of alternative acquisitions structures." University of Chicago M&A modeling case. H. Sapra (2003).

they believe that stock is the least expensive way to finance an acquisition. Or they may prefer to forego a tax-free structure and incur the additional costs of a taxable structure when the costs of stock financing are significantly greater than the costs of debt financing. The analysis in Table 16.4 does not consider these factors.

Additional Complexities

The analysis in Table 16.4 also does not address the impact of sales of acquirer stock by target shareholders postacquisition. Such an outcome is likely, of course, and therefore *quantifying* the impact of those subsequent sales on a seller's wealth is important. Sale of the stock will trigger a tax liability for these shareholders, which they should consider when evaluating the structure and pricing of a transaction.

Table 16.5 presents an analysis similar to that shown in Table 16.4, but we now assume that target shareholders sell the acquirer stock received in the acquisition 2 years after the acquisition. We also assume that the acquirer's stock price appreciates postacquisition at a rate of 12.5% pretax and that the after-tax discount rate is 10.114%.³³

The first four columns of Table 16.5 compute the present value of target shareholder tax liabilities associated with the various tax-free structures assuming that target shareholders sell the acquirer stock 2 years after the acquisition while maintaining the same assumptions employed in Table 16.4. The tax-free structures continue to leave the target's shareholders with more wealth after tax than the taxable structure, but the spread is much narrower than in Table 16.4. For example, target shareholders' after-tax wealth under the Section 368 "B" structure is \$573.66 in Table 16.5, while in Table 16.4 the same structure left target shareholders with \$685 after tax.

The difference between Table 16.4 and 16.5 is the benefit of permanent tax deferral in the first table. The present value of the *tax liability* associated with the Section 368 "B" structure in Table 16.5 is \$111.34. Stated another way, the present value of permanently deferring shareholder capital gains in a Section 368 "B" transaction is \$135 (\$685 after-tax wealth in a Section 368 "B" with permanent deferral less \$550 after-tax cash in a taxable stock acquisition). So the net tax savings with the "B" structure in Table 16.5 is \$23.66 (\$135 tax liability with a taxable stock acquisition less \$111.34 present value tax liability with the tax-free "B" structure). Notice as well that the pretax price required to leave target shareholders indifferent in Table 16.5 is dramatically more than it was in Table 16.4. For example, in Table 16.5, the target shareholders' indifference price in a "C" reorganization is \$662.23, while in Table 16.4, the comparable figure is \$572.92.

When performing an analysis like that in Table 16.5, we should identify the impact of changes in the key input variables—for example, target shareholder basis in the target's stock—on the indifference price. For example, as the target shareholders' stock

³³These computations are very sensitive to assumptions about the relation between pretax and after-tax rates of returns. Various legitimate assumptions can be made about the pretax return to acquirer stock relative to the pretax return available to shareholders receiving cash. Differences in pretax and after-tax returns could arise from, among other factors, differences in the timing of taxation (deferral vs. current taxation). Financial models like the ones in Table 16.4 and Table 16.5 can be used to analyze the sensitivity of target shareholder after-tax wealth to various pretax rates of appreciation or depreciation. The analyses presented in Chapter 3 dealing with the returns for various investment vehicles relate closely to these estimates and analyses.

basis declines, they are willing to take relatively less total consideration in a transaction that provides tax deferral. Similarly, the 1997 reduction in individual investor capital gains tax rates from 28% to 20% increased the amount of tax-favored consideration that must be provided to target shareholders relative to tax-disfavored consideration.³⁴ A shareholder, with a zero basis in the target stock, who receives \$1 of taxable consideration before 1997 would have \$.72 after tax. The same shareholder receiving \$1 of taxable consideration after 1997 will have \$.80 after tax. Therefore, an acquirer will have to offer a larger quantity of tax-favored consideration pretax after 1997, relative to before 1997, to leave the target shareholder as well off after tax.

We cannot provide a concrete decision rule to determine which acquisition structure is optimal. However, in conjunction with an understanding of the nontax differences in acquisition structure (see Tables 14.1 and 16.1), the analyses in this section provide a good starting point to begin such a task. Overall, the analyses in Tables 16.4 and 16.5 provide a framework from which to analyze the optimal tax structure for an acquisition. Further realistic complications to a model like the one presented here could include incorporation of target NOLs, various types of target shareholders, changing tax rates, and structure-related earnings effects. We leave such analyses to readers as an exercise.

Implications for Corporate Valuation

Although this text does not focus on valuation, our analyses in this chapter and the prior two chapters have some potentially important consequences for valuation. In particular, the simple models in Tables 16.4 and 16.5 suggest that the pricing of corporate acquisitions is related to the tax structure selected in the transaction. A standard preacquisition analysis employed by investment bankers compares the terms and price of a proposed acquisition to the terms and price of historical acquisitions that are deemed similar to the pending transaction. Such procedures are broadly called **comparable analysis**.

Figure 16.6 presents an example of a fairness opinion from an investment bank. A fairness opinion is prepared in most acquisition transactions. The purpose of the opinion is to provide assurance to shareholders of the acquirer and/or the target that the pending acquisition is priced fairly. Point 11 of the investment banker's letter refers to a comparable analysis. A comparable company analysis compares the acquisition price and the acquisition premium associated with the acquisition of companies similar to the target company. This kind of exercise may illustrate important differences between a subject company and comparable companies that materially affected the price of comparable companies. For example, a comparable target firm's shareholder tax basis may have been higher or lower than that of the subject company. Such tax differences may therefore influence the negotiated price for the pending transaction as illustrated in Tables 16.4 and 16.5. Executives, advisors, and tax planners, as part of their overall planning for a merger or acquisition, should consider how tax factors such as selling shareholder tax basis, transaction tax structure, target firm tax attributes, and acquiring firm tax rates affected acquisition prices and premiums in comparable company analyses.

³⁴Tax-favored consideration would be consideration (form of payment) that provides tax deferral. Tax-disfavored consideration on the other hand would lead to immediate taxation or less tax deferral.

FIGURE 16.6

Appendix C**Fogel, Lucas, Miller & Co.**295 Park Avenue
New York, NY 10107
(212) 494-9000**November 13, 1995**The Brantingham Company
900 South Buena Vista Street
Burbank, CA 91521

Dear Sirs:

We understand that The Brantingham Company ("Brantingham") and North Drop Inc. ("North Drop") have entered into an Amended and Restated Agreement and Plan of Reorganization, dated as of July 31, 1995, (the "Reorganization Agreement") pursuant to which (i) a new holding company will be formed, which will be renamed "The Brantingham Company" ("New Brantingham"), (ii) newly formed subsidiaries of New Brantingham will be merged with and into each of Brantingham and North Drop, (iii) each share of Brantingham common stock will be converted into one share of New Brantingham common stock and (iv) each share of North Drop common stock will be converted into either New Brantingham common stock or cash, or a combination thereof, based on each stockholder's election and subject to certain proration provisions, such that in the aggregate North Drop stockholders will receive the value equivalent of one share of Brantingham common stock plus \$65 in cash per share of North Drop (the "Transaction"). You have provided us with the joint Proxy Statement/Prospectus, which includes the Reorganization Agreement, in substantially the form to be sent to the shareholders of Brantingham and North Drop, respectively (the "Proxy Statement").

You have asked us to render our opinion as to whether the Transaction is fair, from a financial point of view, to the stockholders of Brantingham.

In the course of our analysis for rendering this opinion, we have:

1. reviewed the Proxy Statement;
2. reviewed North Drop's Annual Reports to Shareholders and Annual Reports on Form 10-K for the fiscal years ended December 31, 1992 through 1994, and its Quarterly Reports on Form 10-Q for the periods ended April 2, July 2 and October 1, 1995;
3. reviewed certain historical financial statements and certain budget financial statements by business segments of North Drop. Provided to us by North Drop management;
4. reviewed Brantingham's Annual Reports to Stockholders and Annual Reports on Form 10-K for the fiscal years ended September 30, 1992 through 1994 and its Quarterly Reports on Form 10-Q for the periods ended December 31, 1994 and March 31 and June 30, 1995;
5. reviewed certain operating and financial information provided to us by Brantingham management relating to Brantingham's and North Drop's businesses and prospects, including financial forecasts of Brantingham and North Drop, respectively, prepared by Brantingham management;
6. met with North Drop's Chief Financial Officer to discuss North Drop's historical and certain budget financial statements by business segment;
7. met with certain members of Brantingham's senior management to discuss its operations, historical financial statements and future prospects;
8. reviewed the pro forma financial impact of the Transaction on the stockholders of Brantingham;

(continued)

FIGURE 16.6 *(continued)*

9. reviewed the historical prices and trading volumes of the common stock of North Drop and Brantingham;
10. reviewed certain publicly available financial data and stock market performance data of companies which we deemed generally comparable to North Drop and/or Brantingham;
11. reviewed the terms of certain other recent acquisitions of companies and businesses which we deemed generally comparable to North Drop and its component businesses and
12. conducted such other studies, analyses, inquiries and investigations as we deemed appropriate.

In the course of our review, we have relied upon and assumed without independent verification the accuracy and completeness of the financial and other information provided to us by North Drop and Brantingham as well as the completeness of the financial and other information provided to us by SEC filings of North Drop and Brantingham respectively. With respect to the financial forecasts provided to us by North Drop and Brantingham we have assumed that they have been reasonably prepared on bases reflecting the best currently available estimates and judgments of the managements of North Drop and Brantingham as to the expected future performance of North Drop and Brantingham, respectively. We have not assumed any responsibility for the information or financial forecasts provided to us and we have further relied upon the assurances of the managements for North Drop and Brantingham that they are unaware of any facts that would make the information or financial forecasts provided to us incomplete or misleading. In arriving at our opinion, we have not performed or obtained any appraisals of the assets of North Drop or Brantingham and except as described in paragraphs 3, 5 and 6 above, we have not had discussions with management or employees of North Drop regarding North Drop's operations, historical financial statements and future prospects or had access to financial forecasts of North Drop prepared by North Drop. Our opinion is necessarily based on economic, market and other conditions, and the information made available to us as of the date hereof.

Based on the foregoing, it is our opinion that as of this date, the Transaction is fair, from a financial point of view to the stockholders of Brantingham.

We have acted as financial advisor to Brantingham in connection with the Transaction and will receive a fee for such services.

Very truly yours,

Fogel, Lucas, Miller & Co. Inc.

By /s/ Elizabeth Anne Erickson

Managing Director

Trends in Acquisition Volume and Structure Across Time

Several sources contain information about trends in the structure of acquisitions of freestanding corporations and the pricing (premium) associated with those deals. *Mergerstat Review* and Securities Data Corporation are two sources that provide relatively comprehensive acquisition information. Readers may find such data useful, particularly with respect to the issues already discussed. That is, these sources provide summary information on purchase price premiums and deal structures across time and, to a lesser extent, industry. Such data is potentially useful in planning the structure and pricing of a pending transaction. Transaction-by-transaction merger and acquisition

data (for example, deal structure, form of payment, premium, target industry) are available from the same sources, among others, in electronic and hard copy form.

16.8 COMPARISON OF TAXABLE AND TAX-FREE ACQUISITIONS OF FREESTANDING C CORPORATIONS

You should now be armed with a solid understanding of the tax and nontax issues associated with various types of acquisitions. But how do we use this knowledge when planning for the acquisition of a freestanding company? In this section, we briefly synthesize the differences in taxable and tax-free acquisitions and introduce a more complex tax-deferred technique with which to acquire a freestanding C corporation.

Table 16.6 compares various tax and nontax factors associated with seven tax structures commonly used to acquire freestanding C corporations. Three of the structures are taxable and four are tax-free. Of these seven structures, the methods presented in the last five columns are the most common. These five structures are actually quite similar in many respects. Notice that in each of these transactions, the target's assets are not stepped up, the tax attributes of the target survive, and tax-based goodwill is not created. The structures do differ in terms of what is acquired (stock or assets), the status of the target's liabilities, the acquirer's source of deal financing, and whether an immediate gain is recognized by target shareholders on the transaction.

Whether to obtain the stock or the assets of the target is an important decision for an acquirer, because when the target's stock is acquired all its liabilities are likewise preserved and obtained by the acquirer. When a target is subject to substantial contingent liability, an acquirer may want to consider an asset acquisition structure (subject to the aforementioned caveats). As we saw in Chapter 14, a taxable asset acquisition results in substantial incremental tax costs. Therefore, in such a situation, a tax-free asset acquisition structure is likely the best choice.

In Table 16.4 and Table 16.5 and the associated text, we provide a method to *quantify* the impact of target shareholder capital gains taxes on target shareholder after-tax wealth and on pretax indifference prices across transaction structures. As Table 16.6 illustrates, a major difference between acquisition methods relates to the tax treatment at the target shareholder level. When target shareholders hold highly appreciated stock, they are going to prefer to receive a tax-free consideration. Stated another way, these types of shareholders will demand a higher pretax price in a taxable deal relative to a tax-free deal.

From the acquirer's perspective, the tax structure of the deal influences the manner in which the transaction is financed. For example, if the transaction is a taxable cash deal, the acquirer will most likely obtain the cash from debt-type borrowings. On the other hand, if the transaction is tax-free, the acquirer must purchase the target with its stock and therefore the deal will be primarily or totally stock financed. The acquirer's tax status and relative stock price influences the acquirer's after-tax financing costs associated with each of the tax structures presented in Table 16.6. The acquirer's relative resistance to diluting its ownership will also influence the viability of a tax-free structure. Conversely, target shareholders may prefer to receive

TABLE 16.6 Overview of Tax and Nontax Features of Various Taxable and Tax-Free Acquisition Structures: Freestanding C Corporations

Taxable Structures			Tax-Free Structures				
Tax or Structural Factor	Asset Acquisition Followed by a Liquidation	Stock Acquisition		I.R.C. §368 "A"	I.R.C. §368 "B"	I.R.C. §368 "C"	I.R.C. §351
	With a §338 Election	Without a §338 Election	Cash				
Consideration/method of payment	Cash	Cash	Cash	Stock/cash	Stock	Stock	Mixed but some stock
Consideration required to be tax-free	n/a	n/a	n/a	50% stock	100% stock	80% stock	Varied
Taxable gain recognized by target shareholders?	Yes	Yes	Yes	Partially	No	No	Partially
Step-up in the target's assets	Yes	Yes	No	No	No	No	No
Target's tax attributes survive ⁽¹⁾	No	No	Yes	Yes	Yes	Yes	Yes
What is acquired? (stock or assets)	Assets	Stock	Stock	Assets	Stock	Assets	Stock or assets
Acquirer obtains all of the target's liabilities?	No	Yes	Yes	Yes	Yes	No	No
Tax-based goodwill? ⁽²⁾	Yes	Yes	No	No	No	No	No
Acquirer's finance the acquisition with ⁽³⁾ ?	Debt	Debt	Debt	Stock/debt	Stock	Stock	Stock/debt
Target shareholders ultimately have?	Cash	Cash	Cash	Stock/cash	Stock	Stock	Stock/boot
Primary benefit of the structure	Target share-holders get cash which provides diversification ⁽⁴⁾	Target share-holders get cash which provides diversification ⁽⁴⁾	Target share-holders get cash which provides diversification ⁽⁴⁾	Tax deferral of target shareholder gains ⁽⁵⁾	Tax deferral of target shareholder gains ⁽⁵⁾	Tax deferral of target shareholder gains ⁽⁵⁾	Tax deferral of target shareholder gains ⁽⁵⁾

⁽¹⁾Target tax attributes include net operating loss carryforwards and various types of tax credits among others.

⁽²⁾This row indicates whether any goodwill recorded in the acquisition, for financial accounting purposes, would also be recorded on the tax-basis balance sheet. Tax-based goodwill only occurs when the tax basis of the target's assets are stepped-up.

⁽³⁾In taxable transactions, acquirers almost always pay cash for the target. It is common in these transactions for acquirers to obtain a large portion of the cash from debt related borrowings, although recently, some acquirers have issued stock to the public and used the cash proceeds from the stock issue to purchase target companies. In tax-free acquisitions, the acquirer by definition must use its stock as payment for the target. These deals are therefore by definition stock financed.

⁽⁴⁾When shareholders receive cash in an acquisition, they have the ability to invest the after-tax proceeds from the transaction in a diversified basket of securities. In a tax-free acquisition in which target shareholders receive stock of the acquiring firm instead of cash, they do not have this option.

⁽⁵⁾Target shareholders defer gains on their exchange of target stock for acquirer stock until they sell the acquirer stock. When acquirer stock is sold, target shareholders recognize the taxable gain associated with the acquisition (assuming that acquirer stock has at least retained its value postacquisition).

cash instead of acquiring firm stock if they are averse to holding acquirer stock postacquisition.³⁵

In summary, many important tax and nontax differences characterize transaction structure. Many of the differences are quantifiable and measurable as we have demonstrated.

Advanced Techniques to Provide Diversification and Tax-Free Treatment

A major advantage to a taxable transaction, as illustrated at the bottom of Table 16.6, is the ability to diversify one's holdings with the consideration received in the acquisition. That is, when a seller receives cash, this cash is most likely reinvested in a diversified basket of securities. Stated another way, the receipt of cash is not the objective, simply an *interim step* on the road to reinvestment and diversification. The major advantage to a tax-free transaction structure is the ability to defer capital gains on the sale of target shares. Unfortunately, tax deferral comes at the cost of a loss of diversification relative to the receipt of cash, because target shareholders must hold acquirer stock in order to obtain and maintain tax deferral.

From a tax planning perspective, an ideal transaction structure would be one in which target shareholders receive a tax-free consideration that simultaneously provided diversification. This objective would be met if the acquirer could purchase the target with a security that tracked, for example, the Standard & Poor's 500 Index while simultaneously providing tax deferral. Is this scenario possible? Through the use of derivatives and an **exchange fund**, such an outcome is possible, but at fairly substantial transactions costs. Specifically, target shareholders can receive the right to obtain the return from a diversified basket of securities such as the S&P 500 Index in return for their ownership in the target.

Consider the founding owner of a privately held corporation, which is currently worth \$1 billion, whose basis in the stock of the firm is \$0. The owner's objective is to monetize her ownership in the target corporation in a tax-minimizing manner. A taxable transaction structure would trigger a taxable gain of \$1 billion and a capital gains tax of \$200 million. The seller's after-tax proceeds that could be invested in a diversified basket of assets would be about \$800 million. A traditional tax-free transaction under Section 368 would defer the \$200 million of tax, but the owner would have to assume the risks associated with holding the acquirer's stock instead of a diversified portfolio of assets.

An exchange fund derivative transaction could provide significant benefits to the seller of this privately held corporation.³⁶ For example, if the seller received \$900 million worth of "securities" whose value tracked a well-diversified set of assets—stocks, bonds, real estate—in a tax-free exchange, the seller's after-tax wealth would be higher by \$100 million (\$900 million less \$800 million after tax in a taxable deal priced at \$1 billion). An acquirer could benefit from such a structure because it is able to purchase the

³⁵See A. Rappaport and M. Sirower, "Stock or Cash? The Trade-offs for Buyers and Sellers in Mergers and Acquisitions," *Harvard Business Review* (November–December 1999), p. 147–158, for additional discussion of these issues.

³⁶Periodic proposed changes in the taxation of exchange funds could eliminate the viability of the use of this specific technique. Of course, the tax planning strategy is not affected by legislative changes, only the execution of the strategy changes.

target corporation at a lower *after-tax cost* than would be possible in a taxable cash transaction (see Tables 16.4 and 16.5). In this scenario, the acquirer could purchase the target for \$100 million less after tax than it could in a taxable cash deal (\$1 billion purchase price in a taxable cash deal less \$900 million in a derivative-based tax-free deal). With this acquisition structure variant, the acquirer and seller can divide the tax benefits derived from tax deferral/avoidance.³⁷

Essentially, of course, this example is just a sophisticated illustration of the same premise you have seen throughout the book—tax planning that considers the tax preferences of the buyer and seller can increase the after-tax wealth of both parties.

Summary of Key Points

1. The most common of tax-free reorganization structures are so-called Section 368 A, B, and C reorganizations. “A” reorganizations are statutory mergers, “B” reorganizations involve an acquisition of at least 80% of the target company’s stock solely in exchange for the purchaser’s stock, and “C” reorganizations involve an acquisition of substantially all the target company’s assets primarily in exchange for the purchaser’s stock.
2. Conditions that must be met to qualify as a tax-free reorganization include a business purpose, continuity of shareholder interest, and continuity of the business.
3. Financial accounting consequences (balance sheet and income statement) of reorganizations can differ significantly from their tax consequences and are often alleged to influence the form, whether cash or stock, such transactions take.
4. Corporate reorganization is an area in which nontax factors often dominate tax factors. But the legal form that many transactions take could simply not be explained were it not for tax considerations.
5. Tax-free structures provide tax benefits but are also associated with substantial nontax costs. Specifically, the stock issue associated with a tax-free deal may dilute the control of acquirer shareholders. Target shareholders may resist receiving payment in the form of acquirer stock due to real or perceived risks associated with holding the acquirer’s stock.
6. Any type of acquisition that results in a carryover basis in the target’s assets, taxable or tax-free, triggers limitations on the target’s tax attributes. These limitations can substantially reduce the value of the target’s tax attributes postacquisition.
7. The tax costs and benefits that are traded off in the acquisition of a freestanding company include target shareholder capital gains taxes, target corporation capital gains taxes, target corporation tax attributes, and incremental benefits from stepping up the tax basis of the target’s assets.

Discussion Questions

1. Why might two corporations wish to combine tax-free? How could tax costs inhibit an otherwise efficient combination?
2. Why might an acquirer want to maintain a target company as a separate legal entity and not merge the target into one of its own subsidiaries or buy the target’s assets?

³⁷See “Barry Diller, Vivendi, and Mixing Bowl Partnerships,” J. Robinson, in *Cases in Tax Strategy*, 3rd edition (2003, Pearson/Prentice Hall) for a complex illustration of this type of transaction.

3. What are the tax benefits of using a Section 351 transfer of property to a controlled corporation? In what ways is it superior to a Section 368 reorganization?
4. Why might you expect a cash merger to fetch a higher price for the target's shares than one in which the purchaser's stock is exchanged for the target's stock?
5. What factors might cause you to expect the cash merger and the stock acquisition to be consummated at the same or similar prices?
6. Why would a tax-free stock-for-stock merger be priced higher than a taxable cash acquisition?
7. What are the primary tax and nontax benefits of a:
 - a. Section 368 A tax-free reorganization
 - b. Section 368 B tax-free reorganization
 - c. Section 368 C tax-free reorganization
 - d. Section 351 tax-free acquisition
8. What are the primary tax and nontax costs of a:
 - a. Section 368 A tax-free reorganization
 - b. Section 368 B tax-free reorganization
 - c. Section 368 C tax-free reorganization
 - d. Section 351 tax-free acquisition
9. Under what general circumstances is a taxable acquisition structure preferable? Consider specifically the tax attributes and tax status of the target corporation and the target's shareholders. Also consider the tax preferences and nontax circumstances of the acquiring corporation.
10. Under what general circumstances is a tax-free acquisition structure preferable? Consider specifically the tax attributes and tax status of the target corporation and the target's shareholders. Also consider the tax preferences and nontax circumstances of the acquiring corporation.

Tax Planning Problems

1. Assume the following factors in assessing the value of preserving NOLs in the acquisition of a target:
 - The target corporation has NOLs of \$675.
 - The net basis in the target's assets is \$200.
 - The cash price that an acquirer is willing to pay for the stock of the target is \$900.
 - Target shareholders have a basis in the stock of the target of \$400.
 - The corporate tax rate is 35%.
 - The shareholder capital gains tax rate is 20%.
 - The after-tax discount rate is 10%.
 - Any step-up in the tax basis of the target's assets is amortized over 10 years on a straight-line basis.
 - The appropriate long-term tax-exempt rate applicable to target NOLs under Section 382 is 4%. The target's NOLs will expire in 20 years.
 - a. Should the acquirer make a Section 338 election and use the target's NOLs to offset any gain on the step-up, or should it forego the election and preserve the target's NOLs?
 - b. What if the step-up in the tax basis of the target's assets is amortized straight-line over a 15-year period, and the long-term tax-exempt rate applicable to target NOLs under Section 382 is 4.75%? Should the acquirer make a Section 338 election and use the target's NOLs to offset any gain on the step-up, or should it forego the election and preserve the target's NOLs?

2. Here is a set of facts about the pending acquisition of Baja, Inc. (the target) by Calstar, Inc. (the acquirer).
 - Baja, Inc. is owned by Smith and Calegari. Smith owns 30% of Baja's common stock and has a basis in his Baja, Inc. stock of \$10. Calegari owns the remaining 70% of Baja stock and has a basis in his stock of \$1,000.
 - Calstar, Inc. wants to acquire Baja and is willing to pay \$100,000.
 - Calstar's outstanding common stock is currently worth \$50,000. Calstar management owns approximately 45% of the currently outstanding common stock.
 - Baja possesses valuable patents, licenses, and other intangible assets that cannot be sold and has assets with titles that are nontransferable.
 - Baja does not have substantial contingent liabilities.
 - Calegari will not sell unless he receives only cash for his Baja stock.
 - Smith will not sell unless he receives consideration that is tax-free.
 - Calstar's management will not purchase Baja with its common stock, which would significantly reduce its voting control.

What acquisition structure would you recommend for this transaction (please mention the Tax Code section)? Diagram the structure and provide details and description as necessary. Be concise.

3. It was announced today that Matrix Inc. will acquire Cajun Systems. Cajun Systems has assets with a tax basis of \$5 billion and has \$1 billion of liabilities. Prior to being acquired, Cajun Systems had no goodwill on its tax books, although it had approximately \$2 billion of goodwill on its financial statements. Cajun's identifiable assets, which include intangible assets other than goodwill, are estimated by Matrix to have a fair market value of \$9 billion and its liabilities have a fair market value of \$1 billion.

Cajun has two primary classes of shareholders. The first consists of taxable investors, who own 15 million of Cajun Systems outstanding shares with an aggregate basis of \$2 billion. For simplicity, assume these stockholders have all held Cajun stock more than 18 months and all purchased the stock at the same price. The second consists of various nontaxable entities, including pension funds and certain foreign investors, who own the remaining 5 million of Cajun's outstanding shares and have an aggregate basis of \$1 billion.

Neither Matrix nor Cajun Systems has any net operating loss carryovers, and both face a 35% tax rate. Assume any boot is taxable at capital gains rates of 20%. Except for the facts given, assume the transaction otherwise meets the requirements for pooling of interests accounting.

Matrix gives voting stock in itself in exchange for all of the outstanding stock of Cajun Systems (a Section 368 "B" structure). Cajun becomes a wholly owned subsidiary of Matrix. At the time of the exchange, the Matrix stock given has a market value of \$10 billion.

- a. What tax basis will Matrix take in the stock of Cajun Systems acquired?
- b. What tax basis will Cajun (and Matrix through its ownership of Cajun) have in its net assets, or assets less liabilities, following the acquisition?

Instead, assume Matrix gives voting stock in itself of \$7.5 billion and cash of \$2.5 billion, and Cajun is merged under state law into a newly created, wholly owned acquisition subsidiary of Matrix called Newco, a Section 368 "A" structure.

- c. Assuming that the cash portion of the purchase price all goes to the nontaxable investors, and the entire stock portion of the purchase price goes to the taxable investors. How much tax will the Cajun shareholders pay in aggregate at the time of the sale?

- d. Now assume instead that the cash and stock portions of the purchase price are prorated, so that each Cajun shareholder gets a package of cash and Matrix stock. That is, every share of Cajun stock is exchanged for \$125 cash and \$375 of Matrix stock. How much tax will Cajun shareholders pay in aggregate at the time of the sale?
 - e. Assuming the structure outlined in part (b), what tax basis will Newco have in the net assets of Cajun?
 - f. Assuming the structure outlined in part (b), how much tax-deductible goodwill will Matrix/Cajun have postacquisition?
4. The following table contains the facts for this problem. You are working for Cabo (the acquirer) who wants to purchase Golden Gate. Cabo is considering a taxable stock purchase at a price of \$150,000 or some type of tax-free acquisition.

Fact Pattern for Problem 4

Purchase price	\$150,000.00
Net tax basis of target's assets	20,000.00
Target shareholder's basis in target stock	5,000.00
t_c	35%
t_{cg}	20%
Estimated holding period for acquiring firm stock obtained in the merger	4 years
Estimated pretax appreciation in acquirer stock postacquisition	12.500%
r	10.324%

	Tax-Free Acquisition Structures			Taxable Structure
	Section 368 "A" (1)	Section 368 "B" (2)	Section 351 (4)	Stock Sale without a Section 338 Election
Purchase price:	\$150,000.00	\$150,000.00	\$150,000.00	\$150,000.00
Cash component	60,000.00	0.00	90,000.00	150,000.00
Stock component	90,000.00	150,000.00	60,000.00	0.00

Based on the facts and the data in the table directly above:

- a. What is Golden Gate shareholders' after-tax wealth under a Section 368 "A" structure based on the terms presented in the table?
- b. What is Golden Gate shareholders' after-tax wealth under a Section 368 "B" structure based on the terms presented in the table?
- c. What is Golden Gate shareholders' after-tax wealth under a Section 351 structure based on the terms presented in the table?
- d. At what pretax purchase price in a Section 368 "A" will the shareholders of Golden Gate be indifferent, relative to a taxable stock purchase at \$150,000?
- e. At what pretax purchase price in a Section 368 "B" will the shareholders of Golden Gate be indifferent, relative to a taxable stock purchase at \$150,000?
- f. At what pretax purchase price in a Section 351 are the shareholders of Golden Gate indifferent, relative to a taxable stock purchase at \$150,000?
- g. Ignoring nontax costs, will Cabo prefer one of the tax-free structures relative to the taxable stock acquisition at \$150,000? Why?
- h. How large would the nontax costs of a Section 368 B have to be to cause Cabo to prefer the taxable stock acquisition at a price of \$150,000 relative to the Section 368 B at the pretax price computed in part (f)?

5. It was announced today that Florida, Inc., will acquire Menlo Park, Inc. Menlo Park has assets with a gross tax basis of \$6 million and has \$1.5 million of liabilities. Prior to being acquired, Menlo Park had no goodwill on its tax books, although it had approximately \$2 million of goodwill on its financial statements. Menlo Park's identifiable assets, which include intangible assets other than goodwill, are estimated by Florida to have a fair market value of \$22 million, and its liabilities have a fair market value of \$1.5 million.

Menlo Park has two primary classes of shareholders. The first consists of taxable investors, who own 1,200 of Menlo Park's outstanding shares with an aggregate basis of \$10 million. For simplicity, assume these stockholders have all held Menlo Park stock more than 12 months and all purchased the stock at the same price. The second consists of various nontaxable entities such as pension funds and certain foreign investors that own the remaining 800 outstanding Menlo Park shares. These stockholders have an aggregate basis of \$1 million.

Neither Florida nor Menlo Park has any net operating loss carryovers, and both face a 35% tax rate. Assume any boot is taxable at capital gains rates of 20%.

Florida gives voting common stock in itself in exchange for all of the outstanding stock of Menlo Park, a Section 368 "B" structure. Menlo Park becomes a wholly owned subsidiary of Florida. At the time of the exchange, the Florida stock given has a market value of \$20 million.

- a. What tax basis will Florida take in the stock of Menlo Park acquired?
- b. What tax basis will Menlo Park and Florida through its ownership of Menlo Park have in its net assets following the acquisition?

Instead, assume Florida gives voting stock in itself of \$16 million and \$5 million in cash, and Menlo Park is merged under state law into a newly created, wholly owned acquisition subsidiary of Florida, called Biscayne, Inc., which is a triangular 368 "A" structure.

- c. Assume that the cash and stock portions of the purchase price are prorated so that each Menlo Park shareholder gets a package of cash and Florida stock. That is, every share of Menlo Park stock is exchanged for \$2,500 cash and \$8,000 of Florida stock (\$10,500 of consideration per share of stock multiplied by 2,000 shares outstanding is \$21 million). How much tax will Menlo Park's shareholders pay in aggregate at the time of the sale?
 - d. What tax basis will Florida's Biscayne subsidiary have in the net assets of Menlo Park?
 - e. How much tax-deductible goodwill will Florida/Menlo Park have postacquisition?
6. Assume the following factors in assessing the sensitivity of the optimal acquisition structure when the target has NOLs:
- The target corporation (a freestanding C corporation) has NOLs of \$16,500.
 - The net basis in the target's assets is \$1,800.
 - The cash price that an acquirer is willing to pay for the stock of the target is \$19,275.
 - Target shareholders have a basis in the stock of the target of \$4,000.
 - The corporate tax rate is 35%.
 - The shareholder capital gains tax rate is 20%.
 - The after-tax discount rate is 7%.
 - Any step-up in the tax basis of the target's assets is amortized over 15 years on a straight-line basis.
 - The appropriate long-term tax-exempt rate applicable to target NOLs under Section 382 is 5%. The target's NOLs will expire in 12 years.

- a. Should the acquirer make a Section 338 election and use the target's NOLs to offset any gain on the step-up, or should it forego the election and preserve the target's NOLs?
- b. Now instead assume that the after-tax discount rate is 9%. What structure—to make or forego the Section 338 election—do you recommend?
- c. Starting with the part (a) assumptions, assume instead that the target's NOLs expire in 17 years and the after-tax discount rate is 7%. What structure—to make or forego the Section 338 election—do you recommend?
- d. Starting with the part (a) assumptions, assume instead that the step-up in the tax basis of the target's assets is amortized over 20 years and the after-tax discount rate is 11%. What structure—to make or forego the Section 338 election—do you recommend?

References and Additional Readings

Cases:

Erickson, M., 2003. "Comparing the Proposed Acquisitions of MCI by British Telecom, GTE and WorldCom," in *Cases In Tax Strategy*, edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.

Robinson, J. 2003. "Barry Diller and Vivendi's Mixing Bowl Partnership," in *Cases In Tax Strategy*, edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.
See list at the end of Chapter 13.