

TAXABLE ACQUISITIONS  
OF FREESTANDING  
C CORPORATIONS

After completing this chapter, you should be able to:

1. Understand the types of acquisitions that result in a step-up in the tax basis of the target's assets and those types that do not.
2. Compute the prices at which a seller (target shareholders) and an acquirer are indifferent between various taxable acquisition structures.
3. Estimate the acquirer's tax basis in the target's stock and assets.
4. Understand the effect of acquisition structure on the target firm's tax attributes.

In Chapter 13 we introduced the major tax issues associated with corporate combinations and divestitures. In this chapter we focus on taxable acquisitions of freestanding C corporations. We consider the taxable acquisitions of an S corporation in the following chapter and the taxable acquisition of a division or a subsidiary of a corporation in Chapter 17.

In a **taxable acquisition**, the purchaser may buy either the assets or the stock of a target company. In the latter case, it is possible via election to treat a stock purchase, for tax purposes, as if the acquirer had purchased the target's assets. If the assets are purchased or if a step-up election is made in a taxable stock acquisition, a stepped-up (or stepped-down) tax basis in the target's assets is achieved. As a result, the acquired inventory will be charged off and the acquired fixed assets will be depreciated from a base equal to their fair market value at the time of acquisition. Tax-deductible goodwill will often result from the step-up in the tax basis of the target's assets.

The step-up in basis is not obtained without a cost, however. A tax must be paid on the ordinary income resulting from the sale of inventory and on any depreciation and other ordinary income recapture, as well as on any taxable capital gains. Prior to 1987, any capital gains associated with stepping up the tax basis of a target's assets were not subject to taxation. The Tax Reform Act of 1986 (TRA 86) made capital gains

associated with asset sales taxable, a legislative change that altered dramatically the tax consequences of taxable mergers and acquisitions.<sup>1</sup>

In an acquisition, the overriding considerations are the following:

1. What are the tax consequences of the transaction for target shareholders?<sup>2</sup>
2. What are the incremental tax costs and tax benefits if the buyer changes the basis in the target's assets?
3. What happens to the target company's tax attributes, including its NOLs?

We begin the chapter with an overview of four cases that cover the broad spectrum of taxable acquisitions of freestanding C corporations, along with the major tax consequences associated with each structure. We defer discussion of tax-free acquisitions until Chapter 16. As part of our analyses, we discuss the structures that are most common and the reasons for the observed empirical regularities. We also discuss nontax aspects of each of these acquisition structures.

## 14.1 TAX CONSEQUENCES OF ALTERNATIVE FORMS OF CORPORATE ACQUISITIONS

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Table 14.1 lays out the major tax consequences—for the **target company**, **acquiring company**, and shareholders of the target company—of the various taxable corporate acquisition structures. We consider four basic acquisition methods:

1. A taxable asset acquisition without liquidating the target corporation
2. A taxable asset acquisition followed by a complete liquidation of the target
3. A taxable stock acquisition followed by a Section 338 election
4. A taxable stock acquisition that is not followed by a Section 338 election

As indicated in Table 14.1, the target company recognizes a gain or loss on the sale if it sells assets, regardless of whether the asset sale is followed by a liquidation, *or* if it sells its stock and the acquirer elects under Section 338 to treat the transaction for tax purposes as a sale of assets. By contrast, neither a sale of stock that is *not* accompanied by a Section 338 election nor a tax-free reorganization generates a taxable gain for the target corporation.

Table 14.1 also shows that the target corporation's recognition of a taxable gain is linked to a change in the tax basis of the assets acquired (to market value) for the purchaser. Moreover, with the exception of a sale of assets by a target company that is not liquidated (Case 1), a change in the tax basis of acquired assets by the purchaser leads to a loss of the **target's tax attributes**, such as net operating loss and tax credit carryforwards.

As for tax consequences to the shareholders of the target company, the general rule is that when shareholders exchange their stock for consideration other than stock of the acquirer, they are taxed on the excess of the value received over their tax basis in the shares. Alternatively, target shareholders recognize a loss equal to the excess of their basis above the purchase price.

Having outlined the basic tax consequences of taxable acquisitions, we next analyze the factors relevant to choosing among the transactional alternatives. After briefly

<sup>1</sup>This change is commonly known as the repeal of the **General Utilities doctrine**.

<sup>2</sup>In general, there are no tax consequences for the shareholders of the acquiring firm.

**TABLE 14.1 Significant Tax Consequences of Various Taxable Acquisition Structures: Acquisitions of Freestanding C Corporations**

<i>Structural or Tax Issue</i>	<i>Asset Acquisition</i>		<i>Stock Acquisition</i>	
	<i>Without Liquidation<sup>(1)</sup></i>	<i>With Liquidation<sup>(2)</sup></i>	<i>With a §338 Election<sup>(3)</sup></i>	<i>Without a §338 Election<sup>(4)</sup></i>
Consideration/method of payment	Cash	Cash	Cash	Cash
Taxable gain at target <i>corporation</i> level	Yes	Yes	Yes	No
Taxable gain recognized by target shareholders	No	Yes	Yes	Yes
Step-up in the <i>tax basis</i> of the target's assets	Yes	Yes	Yes	No
Target's tax attributes survive	Yes	No	No	Yes
Tax deductible goodwill <sup>(5)</sup>	Yes	Yes	Yes	No

<sup>(1)</sup>Transaction in which the target corporation sells its assets to the acquirer for cash. The target corporation pays any resulting tax (or receives a tax refund) on the gain (loss) recognized but the target corporation does not distribute the proceeds of the asset sale to its shareholders.

<sup>(2)</sup>Same as (1), but in this case, the target corporation distributes the after-tax proceeds of the asset sale to its shareholders in redemption of all of their target stock. The target's stock is then cancelled and the target corporation vanishes.

<sup>(3)</sup>Target corporation shareholders receive cash from the acquiring firm in return for their target corporation shares. The acquiring corporation then makes a §338 election, post-stock acquisition, which results in a deemed sale of the target's assets to a phantom new company. This deemed sale results in a step-up in the tax basis in the target's assets.

<sup>(4)</sup>Target corporation shareholders sell their stock to the acquirer, but the acquirer does not make the step-up election (§338 election). There is no step-up in the tax basis of the target's assets; the acquirer takes a carryover basis in the target's assets.

<sup>(5)</sup>Financial accounting goodwill is typically recorded with the purchase method of accounting (required for all transactions post-June 2001). Tax-basis goodwill is only created if the tax basis of the target's assets are stepped-up.

discussing the tax and nontax implications of the four tax structures in Table 14.1, we quantify the differences between them.

### Case 1: Taxable Asset Acquisition without a Complete Liquidation of the Target

This is our benchmark case. In this transaction, the identity of the target's shareholders does not change, and they retain control of the target firm.

The target's shareholders do not pay a direct tax on the asset sale unless they receive a dividend or sell their shares, because they retain their shares in the target company and do not receive any cash in the transaction.

#### Tax Consequences

If a firm sells its assets for a price that exceeds the tax basis in the assets—usually the original acquisition price less accumulated depreciation or amortization since acquisition—it realizes a gain. The way the gain is taxed depends on the nature of the assets sold. For example, gains from the sale of inventories and accounts and notes receivable acquired in the normal course of business for services rendered or inventory sold give rise to ordinary income. Gains from the sale of depreciable property used in a trade or business (so-called Section 1231 property) yield capital gains, except to the extent that past depreciation must be **recaptured** as ordinary income. Sales of **Section 1231 property** at a loss give rise to an **ordinary loss**. Other assets that might be sold, such as stock held for investment, are capital assets, and their sale triggers capital gains or losses. If a corporation suffers a capital loss, the loss can be used only to offset other current or future realized corporate capital gains. Ordinary losses can offset ordinary income or net capital gains.

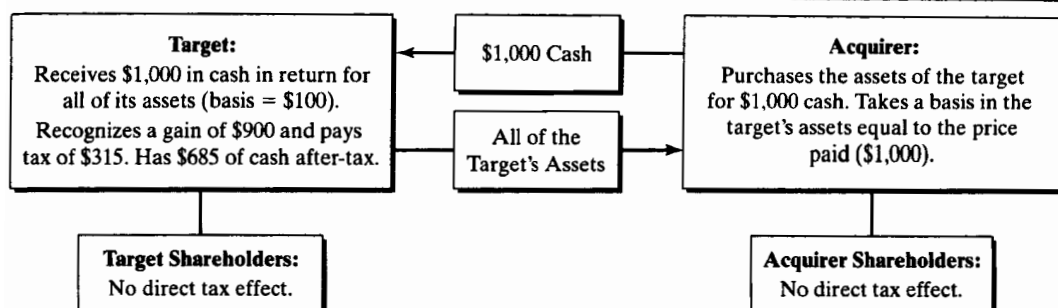
For a comparison of taxable acquisitions of freestanding C corporations, assume the following facts:

- The target corporation (T) has assets with a basis of \$100. **Historical cost** and current basis equals \$100, accumulated depreciation is \$0.
- T's shareholders have a basis in the stock of T of \$100, and they have held the stock for more than 1 year.<sup>3</sup>
- T's shareholders are individual investors, not corporations or tax-exempt entities.
- The acquirer (A) wants to purchase the assets of T for \$1,000.
- T does not have any NOLs, tax credit carryforwards, or loss carryforwards.
- T corporation does not have any liabilities.

Figure 14.1 illustrates the structure of the transaction. In a taxable asset sale without a liquidation of T corporation, T would recognize a gain on the sale of its assets of \$900 (\$1,000 less \$100). This gain would be capital in nature, because the historical cost of T's assets is the same as its current basis. That is, no accumulated depreciation is recaptured and, for this reason, no ordinary income results from the sale. If T's asset

<sup>3</sup>It is extremely unusual for a C corporation's shareholders to have the same basis in their stock as the corporation has in its net assets, because shareholder stock basis does not change with the profits and losses of the company, while the corporation's net asset basis does. Similarly, when shareholders buy and sell shares, the basis of the new shareholders changes independent of changes in the basis in the corporation's net assets. For most publicly traded corporations, shareholder stock basis exceeds the corporation's net asset basis by a substantial margin. Consider, for example, an Internet company with a market capitalization of \$10 billion and net assets of less than \$100 million.

FIGURE 14.1 Taxable Asset Acquisition without a Subsequent Liquidation



basis was less than the historical cost due to depreciation, then the **recaptured depreciation** would be ordinary income.<sup>4</sup> For ease of illustration, we assume that no depreciation has been taken on T's assets. The \$900 capital gain would be taxed, under current law, at T's top marginal tax rate. Ignoring state and local taxes and assuming that T's marginal federal tax rate is the top statutory tax rate (35%), we find that T would face a capital gains tax of \$315 on the asset sale. Because T corporation does not liquidate under this scenario, it would retain all of its tax attributes. After taxes, T corporation therefore would have \$685 (\$1,000 less \$315 of taxes) from the asset sale. T's shareholders do not face any tax on the asset sale as long as T does not liquidate.

In this first of our four cases, the acquirer, A, directly obtains the assets of T. Assuming that T's only asset was a building, A would take a basis in that building equal to the purchase price paid—in this case, a basis of \$1,000. When T corporation is a business comprising many assets—tangible and intangible—the purchase price of the assets is allocated to the tangible and intangible assets based on an appraisal. Specifically, the **residual valuation approach** under **Section 1060** specifies the manner in which the purchase price is allocated to the assets of T.<sup>5</sup> Any portion of the purchase price allocated to goodwill will be amortizable over 15 years under **Section 197**. Returning to our simple numerical example, the acquirer corporation would obtain a step-up of \$900 in the tax basis of T's assets (\$1,000 new basis of T's assets in A's hands less \$100 basis preacquisition). This \$900 step-up gives rise to valuable increased depreciation deductions in future periods. We quantify the value of these additional tax deductions later in this chapter.

### Nontax Consequences

With a taxable asset sale and no liquidation, the acquiring firm purchases the tangible assets of the target and may not acquire certain of its unrecorded liabilities. For example, the contingent liabilities of T corporation generally remain with T corporation. It may also be possible to leave other types of liabilities, such as environmental or

<sup>4</sup>Much of the depreciation recapture may cover various classes of Section 1231 property, and therefore the nature of the gain may be capital rather than ordinary income.

<sup>5</sup>With the residual method, the sale price is first allocated to cash and to cash equivalents. Then the fair market value of marketable securities, certificates of deposit, government securities, foreign currency, and so on, is allocated. This valuation is followed by an allocation of the fair market value to receivables, inventory, fixed assets, and then intangibles such as customer lists, plans, and formulas. The remainder of the purchase price that has not been allocated to specific tangible and intangible assets is allocated to goodwill.

labor-related, with the target corporation when purchasing its assets.<sup>6</sup> However, labor contracts may prohibit the transfer of certain assets without the corresponding transfer of the work force associated with them. In still other cases, facilitating such a contractual transfer may be feasible, but only at significant additional costs. The same may be true for environmental liabilities. Further, while the acquirer may benefit from obtaining the target's assets free of these liabilities, the target corporation may bear the cost. Consequently, the target may demand additional compensation for structuring an acquisition in a manner that leaves it with contingent and other liabilities. In most taxable and tax-free acquisitions, acquirers typically execute the purchase of the target through a subsidiary. Because the target is held in a separate corporate entity (subsidiary of the acquirer), the acquirer obtains some liability protection from the target's liabilities. Readers should note that acquisition of assets does not always protect the acquirer from the liabilities, recorded and unrecorded, of the target firm. As Ginsburg and Levin note, in *Mergers, Acquisitions, and Buyouts*, courts increasingly have held that the contingent liabilities of the target remain with the operating assets of the target's business. Thus, acquirers may be unable to "walk away" from the liabilities of the target, even in an asset purchase. This is a complex issue and deal makers are encouraged to seek the assistance of counsel when dealing with this issue.

When a target sells its assets, the costs of transferring title in each of those assets may be high. Title transfer is required with this structure because the acquirer is actually acquiring not the stock but the assets of the target. When stock is purchased, the acquirer obtains title to the target's assets indirectly through its ownership of the target's stock. Some types of assets are difficult to transfer. For example, certain contracts such as licenses and government permits are unassignable, or unassignable without a third party's consent.

## Case 2: Sale of the Target Firm's Assets Followed by a Liquidation

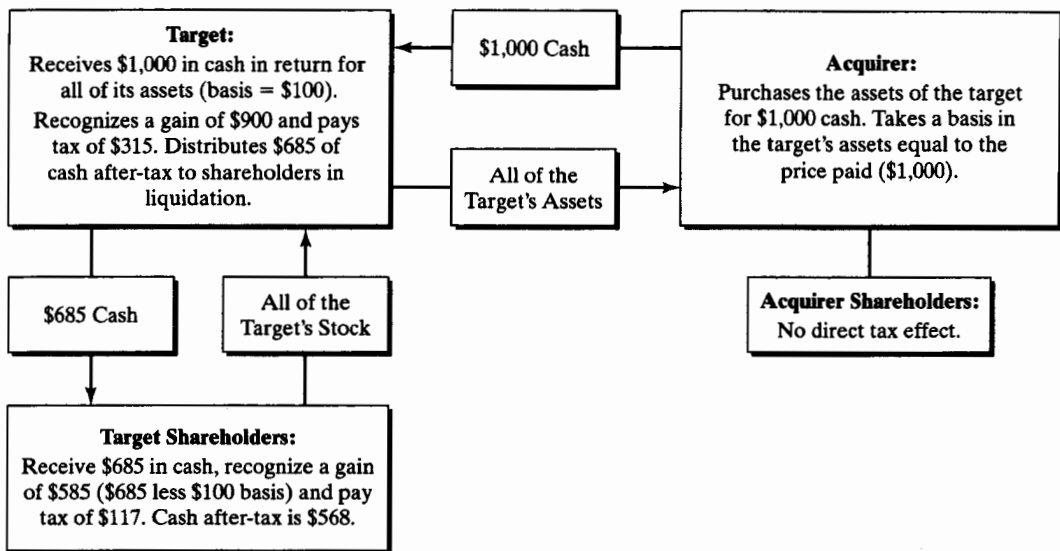
Figure 14.2 illustrates the sale of a target's assets followed by liquidation. This transaction is similar to the transaction described in Case 1, but here the target distributes the after-tax proceeds of the asset sale to its shareholders in return for their T corporation shares in liquidation.

### Tax Consequences

Unlike the situation in Case 1, T corporation's tax attributes vanish when it liquidates. However, if T has NOLs, it can offset both capital gain and ordinary income on the asset sale with its NOLs. We analyze the use of a target's NOLs to offset the gain on a step-up relative to preserving the target's NOLs in Chapter 16.

Returning to our facts from Case 1, we see that the tax consequences of the liquidation to the target corporation would be the same as in that case. The target would recognize a capital gain of \$900 and pay a capital gains tax of \$315. After corporate taxes, the target corporation, T, would have \$685, which it would distribute to its

<sup>6</sup>Acquirers cannot, however, fully avoid the liabilities of the target by acquiring its assets instead of its stock. Ginsburg and Levin (1995), p. 1528, note that "... courts have increasingly held P (the acquirer) responsible for some or all of T's (the target) debts and contingent liabilities (especially tort liabilities for defective products) under the common law doctrines of 'de facto merger' and 'successor liability.' This can occur when T's business has been transferred to P as a going concern and T goes out of existence (especially, but not exclusively, when T's shareholders receive an equity interest in P)."

**FIGURE 14.2** Taxable Asset Acquisition with Subsequent Liquidation of the Target

shareholders in return for all their T stock. T's shareholders would therefore recognize a gain on the stock repurchase of \$585 (\$685 less their basis of \$100).<sup>7</sup> Because we are assuming that T's shareholders have held the T stock for more than 12 months, their capital gain on the stock redemption is long-term. Assume that investors' combined federal and state capital gains income tax rate is 20%, so T's shareholders would face a tax liability of \$117, or 20% of \$585.<sup>8</sup> After-tax, they would therefore have \$568, or the \$685 distribution minus \$117 of capital gains taxes. The acquiring corporation would once again have a basis in T corporation's assets of \$1,000—a \$900 step-up.

### Nontax Consequences

Because the basic structure of the acquisition remains an asset purchase, the nontax consequences are the same as in Case 1.

### Case 3: Purchase of the Target's Stock Followed by a Section 338 Election

As we suggested in Case 1, the nontax costs of acquiring the assets of a target firm with far-flung operations and numerous tangible and intangible assets such as contracts and licenses may make a taxable asset sale structure prohibitive. Most taxable acquisitions of freestanding C corporations are structured as stock acquisitions, in part due to the nontax costs of an asset acquisition. Acquirers may, however, prefer to obtain the step-up in the tax basis of the target's assets associated with a taxable asset acquisition. The Tax Code provides an acquirer with the ability to obtain taxable asset sale treatment in a taxable stock acquisition, thereby avoiding the potentially onerous nontax costs associated with title transfers and nontransferable assets.

<sup>7</sup>Note that if shareholders had purchased T stock at different prices, some may have gains on the liquidation while others would have losses.

<sup>8</sup>In 2003, the top individual investor federal capital gains tax rate was reduced to 15%.

Under Tax Code Section 338, an acquirer can elect to treat a stock purchase of a freestanding C corporation as a taxable asset purchase. The acquirer is eligible to make the Section 338 election if it acquires at least 80% of the stock of the target firm within a 12-month period in a taxable manner, a so-called **qualified stock purchase**. The Section 338 election is made by the acquirer and does not require the consent of the target's shareholders.<sup>9</sup> Figure 14.3 illustrates a taxable stock acquisition of a free-standing target followed by a Section 338 election.

### Tax Consequences

In a taxable stock acquisition followed by a Section 338 election, the target corporation is treated, for tax purposes, as if it sold its **gross assets**<sup>10</sup> to the new target for what is known as the **aggregate deemed sale price (ADSP)**. *ADSP* is computed as:<sup>11</sup>

$$ADSP = P + L + t(ADSP - \text{Basis})$$

where

$P$  = the price paid for the stock of the target

$L$  = is the liabilities of the target (now assumed by the acquirer)

$t$  = the corporate tax rate

Basis = the adjusted tax basis of the target's gross assets

*ADSP* is the gross tax basis of the assets of the target in the hands of the acquirer after the Section 338 election. Notice that the *ADSP* formula is self-referential; that is, *ADSP* is on both sides of the equation. The reason will become clear as we solve for *ADSP* using the numerical facts established in our example.

One fact is different: Here the acquirer is willing to pay \$685 for the stock of the target corporation. We also assume that the acquirer makes a Section 338 election after acquiring the stock of the target. T's shareholders would therefore recognize a gain on the sale of their T stock of \$585 (\$685 less \$100 basis). As before, this gain is capital in nature and under our assumptions, target shareholders would be subject to a capital gains tax of \$117, leaving them with \$568 after-tax. Because the transaction is structured as a stock acquisition, there is no taxable gain at the T corporation level. After the stock sale, T corporation becomes a subsidiary of the acquirer.

The acquiring firm, after obtaining 80% of the stock of the target, makes the Section 338 election. As a result of this election, T corporation (now a subsidiary of A) is deemed to have sold its assets to a hypothetical new target for *ADSP*. *ADSP* equals \$1,000 under our scenario, computed as follows:

$$ADSP = \$685 + \$0 + 35\%(ADSP - \$100)$$

$$ADSP = \$685 + .35ADSP - \$35$$

$$.65ADSP = \$650$$

$$ADSP = \$1,000$$

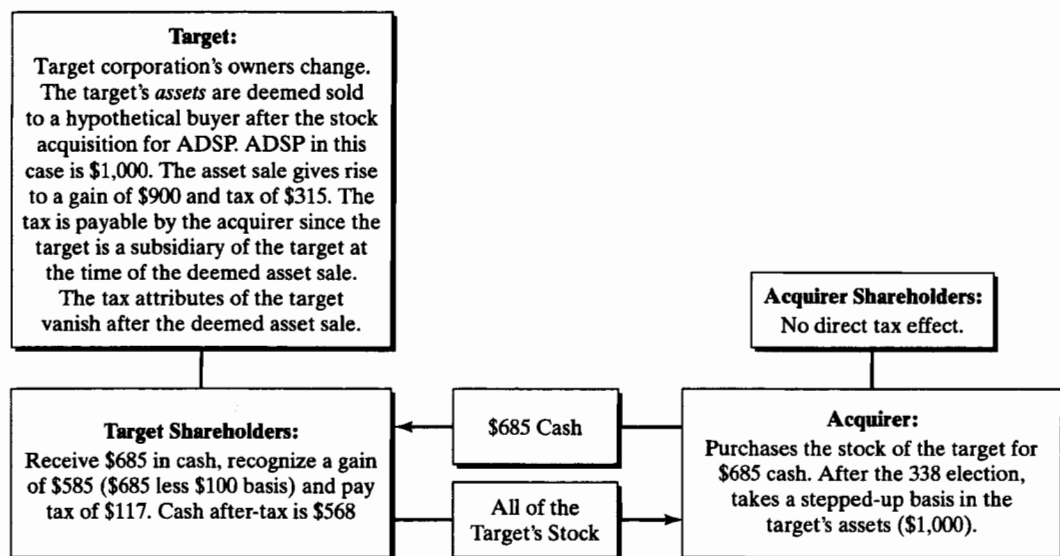
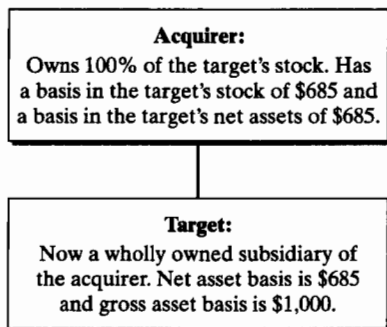
The deemed sale of the target's assets for \$1,000 results in a taxable gain of \$900 (\$1,000 *ADSP* less basis of \$100) at the target corporation level. Assuming the top

<sup>9</sup>The election must be made within 8.5 months of the acquisition.

<sup>10</sup>Gross assets are total assets, while net assets are gross assets less liabilities. Net assets are typically synonymous with owner's equity.

<sup>11</sup>When the target has NOLs, the general form of the *ADSP* computation becomes  $ADSP = P + L + t(ADSP - \text{Basis} - \text{NOL})$ .



**FIGURE 14.3** Taxable Stock Acquisition of the Target with a §338 Election**Postacquisition:**

marginal federal tax rate applies, a tax liability of \$315 results. This tax liability is payable by the target corporation, which is a subsidiary of the acquirer after the stock purchase. In total, the acquirer has paid \$1,000 for the target corporation: \$685 for the target's stock and \$315 for the tax liability associated with the Section 338 election. The *ADSP* computation is self-referential because the acquirer, through the target, contractually pays the tax associated with the Section 338 election. Hence, the deemed price paid for the target's assets (*ADSP*) includes the price paid for the stock *plus* the tax on the deemed asset sale, or  $t(ADSP - \text{Basis})$ . As a result of the election, the acquirer obtains a step-up in the target's assets of \$900 (\$1,000 *ADSP* less \$100 preacquisition basis) and has a gross basis in these assets of \$1,000. Any portion of the purchase price allocated to goodwill will be amortizable over 15 years under **Section 197**.

Unlike the case in a taxable asset acquisition, in a taxable stock acquisition, the acquirer has a tax basis in the stock and the assets of the target. Under the current scenario, the acquirer would have a basis in T's stock of \$685 and a basis in T's gross

assets of \$1,000. The **net asset basis** of the target's assets would be \$685, or \$1,000 gross basis less \$315 tax liability arising from the Section 338 election. As a result of the Section 338 election, T corporation's tax attributes vanish, but its NOLs can be used to shield the gain associated with the step-up in its asset basis. The *acquirer's* NOLs cannot be used to offset the gain on the step-up, however.

### **Nontax Consequences**

Several nontax benefits are associated with a taxable stock acquisition. First, the transaction costs of obtaining the stock of a freestanding target are likely to be much smaller than the title transfer costs associated with an asset sale. Second, the problem of nontransferable assets is largely avoided with a stock acquisition, thereby providing the potential for significant nontax benefits in certain circumstances.

Several significant nontax costs are also associated with this structure. Unlike the case in an asset sale, the target corporation in a stock acquisition survives as a legal entity including its contingent liabilities. However, because the target becomes a *corporate* subsidiary of the acquirer, it enjoys some protection from legal liabilities through the properties of corporate ownership. That is, the acquirer's losses associated with the acquired firm should, in most cases, be limited to the amount paid for the target.

### **Case 4: Purchase of the Target's Stock without a Section 338 Election**

Case 4 is the same as Case 3 except that the acquirer does not make the Section 338 election. The numerical facts remain the same, and the structure employed is nearly the same as Figure 14.4 illustrates.

### **Tax Consequences**

With a taxable stock acquisition, the target's shareholders recognize a taxable gain equal to the purchase price less their basis in T's stock. Given the numbers in this case, target shareholders recognize a capital gain of \$585 (\$685 less \$100 basis) on the stock sale to the acquirer and have \$568 after tax. The target corporation's tax attributes survive, but are limited by **Section 382**.

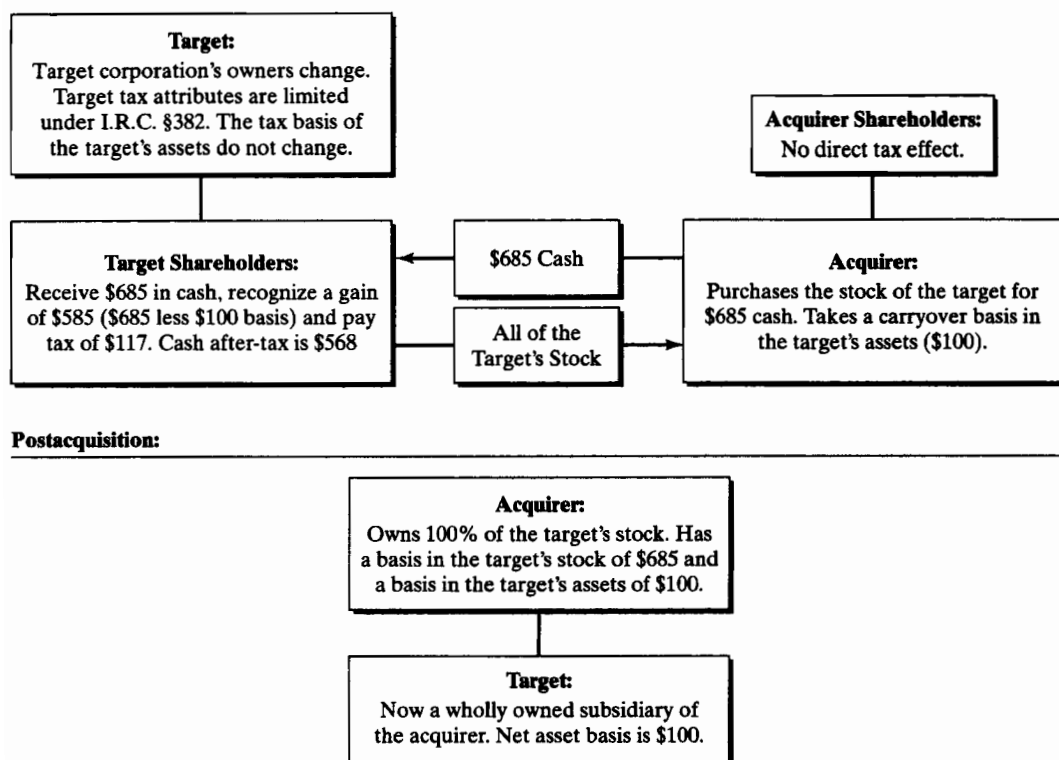
The acquiring firm obtains the stock of the target firm and takes a basis in this stock equal to the purchase price paid, which is \$685. The target becomes a subsidiary of the acquirer and because the acquirer did not make the Section 338 election, the asset basis of the target is not stepped-up for tax purposes. Therefore, the target's asset basis carries over and is \$100 postacquisition. Notice that the acquirer's tax basis in the stock and assets of the target are \$685 and \$100, respectively.

### **Nontax Consequences**

The nontax consequences of this transaction structure are essentially the same as those described for Case 3. One notable difference between Cases 3 and 4 occurs in the tax and financial accounting basis of the assets of the target. In Case 3, the gross financial accounting basis in the assets of the target would be approximately \$1,000<sup>12</sup> as would the gross tax basis of the target's assets.

However, in Case 4, the acquirer's gross financial accounting basis in the target would be \$685 while the gross tax basis of the target's assets postacquisition is \$100. This

<sup>12</sup>This estimate ignores the effects of merger costs, such as investment banking fees, as well as other such items. The net asset tax basis is \$685 as is the net financial accounting basis.

**FIGURE 14.4** Taxable Stock Acquisition of the Target without a §338 Election

difference in financial accounting and tax basis is often manifested to a large degree in the goodwill account on the acquirer's financial statements. That is, the acquirer will have a large amount of recorded goodwill that is *not* tax deductible under Case 4.<sup>13</sup> Under Case 3, any goodwill recorded in the acquisition will be tax deductible.

## 14.2 COMPARISON OF TAXABLE ACQUISITION STRUCTURES

The four preceding examples present the tax implications of the various taxable acquisition structures used when purchasing a freestanding C corporation. Even though that information is valuable, our objective is applying that knowledge to a tax planning problem. Which of these structures is best given the specific fact pattern presented? When does each of these structures become preferential?

Based on the preceding facts, which structure is optimal, from a tax perspective only? As demonstrated in prior chapters, we can solve for the optimal contract by setting one party indifferent and determining which contract the other prefers. Table 14.2 lays out the tax implications of the four structures discussed in section 14.1. Essentially what

<sup>13</sup>This disparity in the book and tax basis of the target's assets generate a significant deferred tax liability. There are reasons that firms should not record such a deferred tax liability. Those reasons are beyond the scope of this text.

**TABLE 14.2** Comparison of the Tax Effects of Various Taxable Acquisition Structures: Acquisitions of Freestanding C Corporations**Fact Pattern:**

Asset purchase price	\$1,000.00
Stock purchase price	\$685.00
$ADSP^{(1)} =$	\$1,000.00
Target's net asset basis	\$100.00
Target shareholder's stock basis	\$100.00
$t_c =$	35%
$t_{cg} =$	20%
$r =$	10%
Amortization/depreciation period ( $n$ ) =	10

	Transaction Structure			
	Asset Acquisition		Stock Acquisition	
	No Liquidation	Liquidation	With a \$338 Election	Without a \$338 Election
<b>Purchase Price</b>	\$1,000.00	\$1,000.00	\$685.00	\$685.00
<b>Tax Costs:</b>				
Tax paid by T corporation <sup>(2)</sup>	(315.00)	(315.00)	0.00	0.00
Tax paid by A from the \$338 election <sup>(3)</sup>	0.00	0.00	(315.00)	0.00
Tax paid by T's shareholders <sup>(4)</sup>	0.00	(117.00)	(117.00)	(117.00)
<b>Total Tax Paid</b>	<u>(\$315.00)</u>	<u>(\$432.00)</u>	<u>(\$432.00)</u>	<u>(\$117.00)</u>
<b>Target Shareholder Consequences:</b>				
Gross cash received	n/a	685.00	685.00	685.00
Less: shareholder taxes <sup>(4)</sup>	n/a	(117.00)	(117.00)	(117.00)
After-tax cash to target's shareholders	<u>n/a</u>	<u>\$568.00</u>	<u>\$568.00</u>	<u>\$568.00</u>
<b>Acquirer Net After-Tax Cost:</b>				
Gross cost	\$1,000.00	\$1,000.00	\$1,000.00	\$685.00
Less: present value of tax benefits <sup>(5)</sup>	(193.55)	(193.55)	(193.55)	0.00
Net after tax-cost of the acquisition	<u>\$806.45</u>	<u>\$806.45</u>	<u>\$806.45</u>	<u>\$685.00</u>
<b>Acquirer's Tax Basis in the Target's:</b>				
Stock	n/a	n/a	\$685.00	\$685.00
Assets	\$1,000.00	\$1,000.00	\$1,000.00	\$100.00

<sup>(1)</sup> $ADSP$  is the aggregated deemed sale price of the target's assets in a taxable stock transaction in which a \$338 election is made.  $ADSP$  is computed as:  $ADSP = G + L + t_c(ADSP - BASIS)$ ; where  $G$  is the price paid for the target's stock,  $L$  are the target's liabilities,  $t_c$  is the corporate tax rate, and  $BASIS$  is the gross tax basis of the target's assets preacquisition.

<sup>(2)</sup>Tax liability at the target corporation level from the sale of the target's assets preacquisition.

<sup>(3)</sup>Tax liability at the target corporation level on the deemed sale of its assets after the stock acquisition. The liability is ultimately the contractual responsibility, indirectly, of the acquiring firm because when the liability is triggered, the target is a subsidiary of the acquirer.

<sup>(4)</sup>Capital gains taxes resulting from the redemption of target shares by the target corporation in the liquidation following an asset sale and from the direct sale of the shares to the acquirer in the stock acquisitions.

<sup>(5)</sup>The present value of the tax savings resulting from stepping up the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

we have done is set the seller (target shareholders) indifferent between the structures. That is, we computed the acquisition price required under each of the four structures to leave the target's shareholders with the same amount of cash after tax. Notice that the target's shareholders receive \$568 after tax in the three right-hand scenarios in Table 14.2; and were the target to liquidate in Case 1, target shareholders would have \$568 after tax in that scenario also.

To answer the question which structure is optimal (ignoring nontax costs), below we develop algebraic expressions that allow us to determine acquirer and seller indifference prices across various acquisition structures.<sup>14</sup> We use algebra only as a tool.<sup>15</sup>

Target shareholder's after-tax cash under Case 2 (asset sale followed by a liquidation) can be represented by equation (14.1) below. We first define the target shareholder's after-tax wealth as the liquidation proceeds, which is cash distributed by the target corporation after paying the corporate level tax, less the shareholder tax liability associated with the liquidation. We then specify the amount of cash distributed to shareholders in the liquidation algebraically, as a function of purchase price in equation (14.2).

$$\begin{aligned} ATAX_{\text{asset}} &= \text{Liquidation} - \text{Tax on liquidation} \\ &= \text{Liquidation} - (\text{Liquidation} - \text{Stock})t_{\text{cg}} \\ &= \text{Liquidation}(1 - t_{\text{cg}}) + \text{Stock} \times t_{\text{cg}} \end{aligned} \quad (14.1)$$

$$\begin{aligned} \text{Liquidation} &= \text{Price}_{\text{asset}} - \text{Tax on asset sale} \\ &= \text{Price}_{\text{asset}} - (\text{Price}_{\text{asset}} - \text{Asset})t_c \\ &= \text{Price}_{\text{asset}}(1 - t_c) + \text{Asset} \times t_c \end{aligned} \quad (14.2)^{16}$$

where

- $ATAX_{\text{asset}}$  = target shareholder's after-tax cash in a taxable asset sale
- Liquidation = after-corporate-tax liquidation proceeds paid to target shareholders
- Stock = target shareholder's stock basis
- $t_{\text{cg}}$  = the individual investor capital gains tax rate<sup>17</sup>
- $t_c$  = the corporate tax rate (ordinary and capital gain)
- $\text{Price}_{\text{asset}}$  = the price paid to the target corporation for its net assets
- Asset = the net tax basis of the target's assets

Substituting the definition of Liquidation in equation (14.2) into equation (14.1) and simplifying we obtain:

$$ATAX_{\text{asset}} = [\text{Price}_{\text{asset}}(1 - t_c) + \text{Asset} \times t_c](1 - t_{\text{cg}}) + \text{Stock} \times t_{\text{cg}} \quad (14.3)$$

<sup>14</sup>It is important to note that the analysis used ignores target shareholder tax attributes such as capital loss carryforwards, target corporation tax attributes such as NOLs and capital loss carryforwards, and that we assume 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.

<sup>15</sup>Readers who prefer electronic spreadsheet models for such tasks may want to compare the algorithm used in their models to those presented here. The algebraic equations presented here should be logically identical to those in the spreadsheet models.

<sup>16</sup>We ignore the effect of target net operating losses on liquidation proceeds here for ease of illustration. As noted previously, target NOLs can be used to offset the gain associated with stepping up the target's assets.

<sup>17</sup>This rate includes both federal and state income taxes. The top federal capital gains tax rate for individuals is 15%, as of 2003.

We can represent target shareholder's after-tax cash under Case 3 and Case 4 by the following expression

$$\begin{aligned} ATAX_{\text{stock}} &= \text{Price}_{\text{stock}} - \text{TAX} \\ &= \text{Price}_{\text{stock}} - (\text{Price}_{\text{stock}} - \text{Stock})t_{\text{cg}} \\ &= \text{Price}_{\text{stock}}(1 - t_{\text{cg}}) + \text{Stock} \times t_{\text{cg}} \end{aligned} \quad (14.4)$$

where

$ATAX_{\text{stock}}$  = target shareholder's after-tax cash in a taxable stock sale

$\text{Price}_{\text{stock}}$  = the pretax price paid to target shareholders in a taxable stock acquisition, (other variables are as previously defined)

If we set equations (14.3) and (14.4) equal to each other, we find the price demanded by target shareholders in a taxable asset acquisition ( $\text{Price}_{\text{asset}}$ ) given the price demanded in a taxable stock acquisition ( $\text{Price}_{\text{stock}}$ ).

$$\begin{aligned} &\text{Price}_{\text{stock}}(1 - t_{\text{cg}}) + \text{Stock} \times t_{\text{cg}} \\ &= [\text{Price}_{\text{asset}}(1 - t_{\text{c}}) + \text{Asset} \times t_{\text{c}}](1 - t_{\text{cg}}) + \text{Stock} \times t_{\text{cg}} \end{aligned} \quad (14.5)$$

Substituting, rearranging, and simplifying yields the following expression:

$$\text{Price}_{\text{asset}} = (\text{Price}_{\text{stock}} - \text{Asset} \times t_{\text{c}})/(1 - t_{\text{c}}) \quad (14.6)$$

With the facts in Case 4 and given  $\text{Price}_{\text{stock}} = \$685$ ,  $\text{Price}_{\text{asset}}$  is equal to \$1,000, which is computed as  $(\$685 - \$100 \times 35\%)/(1 - 35\%)$  using equation (14.6). Table 14.2 indicates that the numerical solution provided by equation (14.6) does in fact leave target shareholders indifferent between a taxable stock sale at a price of \$685 and a taxable asset sale at \$1,000. That is, target shareholder's after-tax wealth is \$568 in both cases.

Given target shareholder indifference, we then need to determine which of the transaction structures is the least costly to the acquirer after tax. To estimate the after-tax cost of each structure, we need an estimate of the value of the tax benefits associated with stepping up the tax basis of the target's assets. For ease of computation, we assume that the average depreciable/amortizable life of the target's assets is 10 years. Further we assume **straight-line depreciation/amortization**, an after-tax discount rate of 10%, and an appropriate corporate tax rate of 35%.<sup>18</sup> Under those assumptions, the step-up in the target's assets generates \$90 per year (\$900/10-year life) in additional depreciation deductions and \$31.50 in tax savings each year for 10 years, or \$90 multiplied by 35%. At a discount rate of 10%, the present value of the additional tax savings from the depreciation deductions is \$193.55. Table 14.3 presents these computations.

From the acquirer's perspective, in Case 1, the net after-tax cost of acquiring the target is \$806.45, or \$1,000 acquisition cost less \$193.55 in *incremental* tax savings from the step-up. The after-tax cost of acquiring the target under Case 2 is also \$806.45 for the same reason. Under Case 3, the after-tax cost of acquiring the target is the sum of the \$685 paid for the target's stock plus the \$315 tax associated with the Section 338 election less the present value of tax savings from the step-up (\$193.55), which is again

<sup>18</sup>These assumptions are overly general and do not represent the true complexity and economic effects associated with allocating the purchase price to the target's assets. We make these simplifying assumptions here for ease of illustration. It should be noted, however, that the allocation of the purchase price to various target asset classes (e.g., land vs. goodwill) can have a dramatic impact on the cash flows of the combined firm postacquisition.

**TABLE 14.3** Estimation of Tax Benefits from Stepping up the Tax Basis of a Target's Assets**Fact Pattern:**

Purchase price	\$1,000.00
Target's net asset basis	100.00
Step-up <sup>(1)</sup>	900.00
Amortization/depreciation period	10
Depreciation method	straight-line
Annual incremental amortization/depreciation <sup>(2)</sup>	\$90.00
$t_c =$	35.00%
$r =$	10.00%

Period	Incremental Depreciation <sup>(2)</sup>	Tax Savings <sup>(3)</sup>	Present Value of Tax Savings <sup>(4)</sup>
1	\$90.00	\$31.50	\$28.64
2	90.00	31.50	26.03
3	90.00	31.50	23.67
4	90.00	31.50	21.51
5	90.00	31.50	19.56
6	90.00	31.50	17.78
7	90.00	31.50	16.16
8	90.00	31.50	14.69
9	90.00	31.50	13.36
10	90.00	31.50	12.14
Total	<u>\$900.00</u>	<u>\$315.00</u>	<u>\$193.55</u>

<sup>(1)</sup>Step-up is the increase in the tax basis of the target's assets computed as the purchase price less the net asset basis preacquisition.

<sup>(2)</sup>Incremental amortization/depreciation deductions is the step-up divided by the amortization period.

<sup>(3)</sup>Tax savings are incremental amortization/depreciation deductions multiplied by the corporate tax rate ( $t_c$ ).

<sup>(4)</sup>Present value of tax savings discounted at the after-tax rate discount rate ( $r$ ).

\$806.45. Under Case 4, the pretax cost of acquiring the target is \$685, but no incremental tax benefits come from stepping up the tax basis of the target's assets. So after any tax benefits, the acquirer's net cost in Case 4 is \$685.<sup>19</sup> Therefore, the acquirer prefers Case 4 to the other three options. Why? The acquirer's net after-tax cost is lowest under Case 4.

Does this conclusion seem reasonable? The optimal structure in our example is the one in which the tax basis of the target's assets is not stepped up. For each of the first three cases, we can see that the incremental tax cost of stepping up the target's assets is \$315. Under Cases 1 and 2, the target corporation pays this incremental tax,

<sup>19</sup>Each of these four computations ignores the tax benefits attributable to the existing tax basis of the target's assets. The computations do so because those tax benefits are constant across transaction structure. Thus, those tax benefits have no incremental affect on the determination of the optimal tax structure.

while in Case 3 the acquiring firm pays it. In Case 4, no incremental tax cost is associated with stepping up the tax basis of the target's assets.

We also know that the present value of the tax benefits from stepping up the tax basis of the target's assets in Cases 1, 2, and 3 is \$193.55. Therefore, the net *cost* of a step-up is \$121.45, or \$315 less \$193.55. This answer is quite reasonable when we realize that the taxable gain associated with a step-up (\$900) is equivalent to the amount of the step-up. Furthermore, the immediate associated tax liability is equal to the gross amount of tax savings derived from additional depreciation deductions; \$900 step-up multiplied by 35% = \$315 of additional deductions (see Table 14.3) that will be realized in future periods, assuming constant tax rates. With any discount rate greater than 0%, the present value of the tax savings from the step-up will be less than the tax liability due today from the step-up.

As we noted in Chapter 13, acquisitions of freestanding C corporations are rarely structured to result in a step-up in the tax basis of the target's assets. The reason is that it does not make sense to pay \$1 in taxes today to generate \$1 of tax savings over the next 10 or  $n$  years. In our numerical example in Table 14.2, it doesn't make sense to pay \$315 in tax today to generate \$193.55 in present value tax savings.

### Analysis of Acquiring Firm Indifference Price

In equations (14.1) through (14.6) we expressed target shareholder's indifference between taxable acquisition structures algebraically. We can do the same for acquiring firms. Doing so will provide a relatively complete framework for you to analyze the tax consequences of a taxable acquisition of a freestanding C corporation. An acquiring firm's net after-tax cost in a taxable stock acquisition in which a Section 338 election is not made (Case 4) can be expressed as:

$$\begin{aligned} ATAXCOST_{\text{stock}} &= \text{Acqprice}_{\text{stock}} - \text{Incremental tax benefits} \\ &= \text{Acqprice}_{\text{stock}} - \$0 \\ &= \text{Acqprice}_{\text{stock}} \end{aligned} \quad (14.7)$$

where

$ATAXCOST_{\text{stock}}$  = the acquirer's net after-tax cost of the acquisition in a taxable stock transaction in which the target's assets are not stepped up

$\text{Acqprice}_{\text{stock}}$  = the price the acquirer pays for the target's stock in a taxable stock acquisition in which the target's assets are not stepped up

An acquirer's net after-tax cost in a step-up transaction can be expressed as follows. We use a taxable asset acquisition because algebraically, it is less complex than a Section 338 transaction. The results are identical if we use a taxable stock acquisition followed by a Section 338 election.

$$\begin{aligned} ATAXCOST_{\text{asset}} &= \text{Acqprice}_{\text{asset}} - \text{Incremental tax benefits} \\ ATAXCOST_{\text{asset}} &= \text{Acqprice}_{\text{asset}} - [(\text{Acqprice}_{\text{asset}} - \text{Asset})/n] \times PVANN \times t_c \end{aligned} \quad (14.8)$$

where

$ATAXCOST_{\text{asset}}$  = the acquirer's net after-tax cost of the acquisition in a taxable asset acquisition



$\text{Acqprice}_{\text{asset}}$  = the pretax price paid by the acquirer for the target's net assets in a taxable asset acquisition

Asset = the target's net tax asset basis preacquisition

$PVANN$  = the present value of an annuity for  $n$  periods

$t_c$  = the corporate tax rate

$n$  = the period over which the step-up will be depreciated/amortized on a straight-line basis<sup>20</sup>

If we set equations (14.7) and (14.8) equal to each other, we can solve for the maximum price the acquirer will pay in a taxable asset sale, given the price in a taxable stock sale. Also, assume that the price an acquirer will pay in a taxable stock sale ( $\text{Acqprice}_{\text{stock}}$ ) is the same as the price the target will demand ( $\text{Price}_{\text{stock}}$ ) in equations (14.4) through (14.6).

$$\text{Price}_{\text{stock}} = \text{Acqprice}_{\text{asset}} - [(\text{Acqprice}_{\text{asset}} - \text{Asset})/n] \times PVANN \times t_c \quad (14.9)$$

After rearranging, we can express equation (14.9) as

$$\text{Acqprice}_{\text{asset}} = (\text{Price}_{\text{stock}} - \text{Asset} \times \text{Factor} \times t_c) / (1 - \text{Factor} \times t_c)$$

where Factor is equal to  $PVANN/n$ .

Using the facts in Table 14.2, we find that  $\text{Acqprice}_{\text{asset}}$  is equal to

$$\begin{aligned} \text{Acqprice}_{\text{asset}} &= (\$685 - \$100 \times .61445 \times 35\%) / (1 - .61445 \times 35\%) \\ &= \$847.28 \end{aligned}$$

That is, the acquirer is indifferent between paying \$685 in a taxable stock acquisition without a step-up election and paying \$847.28 in a taxable asset sale. If we insert the maximum price the acquirer will pay in a taxable asset sale into equation (14.3), we find that target shareholder's after-tax wealth is \$488.58,<sup>21</sup> which is less than the shareholder receives in a taxable stock sale at a price of \$685. Hence, the taxable stock sale is the optimal structure.<sup>22</sup>

When then would a tax planner want to structure an acquisition of a freestanding company to result in a step-up in the tax basis of the target's assets? As a general rule, this structure makes sense only when the target has large NOLs that can be used to offset the gain on the step-up.<sup>23</sup> Due to limitations on the transfer of target NOLs in acquisitions, which we discuss in Chapter 16, offsetting the gain on a step-up can be an efficient use of the target's NOLs. However, even when the target has NOLs, a step-up structure may be suboptimal.

<sup>20</sup>A formula that reflects the complexities of accelerated depreciation methods and various asset classes (e.g., buildings and equipment) would be more realistic but unwieldy for our purposes. Readers can use the intuition derived from these equations to develop financial models that capture reality more precisely.

<sup>21</sup> $\text{ATA}_{\text{asset}} = [\text{Price}_{\text{asset}}(1 + t_c) + \text{Asset} \times t_c](1 - t_{cg}) + \text{Stock} \times t_{cg}$

$\text{ATA}_{\text{asset}} = [\$847.28(1 - .35) + \$100 \times .35] \times (1 - .20) + \$100 \times .20$

$\text{ATA}_{\text{asset}} = \$488.58$

(14.3)

<sup>22</sup>That is, we reach the same conclusion regarding the structuring of the deal regardless of which party's (acquirer or target shareholders) after-tax wealth is held constant.

<sup>23</sup>A step-up structure also often makes sense in the acquisition of a foreign entity due to the tax treatment of dividend repatriation and the low incremental cost of a step-up structure in such an acquisition.

### 14.3 TAX DEFERRAL THROUGH INSTALLMENT SALE TAX TREATMENT

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Prior to the late 1980s, substantial tax benefits were available from **installment sale** tax treatment. Such tax benefits are still available but at potentially significant nontax costs. Installment sale treatment allows a seller to defer gain recognition until the receipt of cash. In an installment sale transaction, sellers receive a debt instrument of the acquirer with taxable income recognized upon the receipt of periodic interest and principal payments on the security. Interest income is taxed as ordinary income and principal amounts trigger capital gain recognition for target shareholders. Because shareholders receive principal amounts over the life of the debt security, installment sale tax treatment can provide substantial tax savings via deferral.

Under current law, installment sale treatment is only available if the debt instrument received by target shareholders is not publicly traded. The fact that the acquirer's debt cannot trade publicly imposes a significant nontax cost on target shareholders. As a result, installment sale tax treatment has been much less common during the 1990s than it was in the 1980s. Although, installment sale tax treatment is oftentimes a pivotal tax issue in the sale/acquisition of small privately held corporations.

### 14.4 PRACTICAL ISSUES ASSOCIATED WITH STRUCTURING AND PRICING AN ACQUISITION

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In the illustrations and discussion in Section 14.2 we assumed that all target shareholders were of the same type, faced the same tax rate, and had the same tax basis in the target's shares. In reality, of course, a target's shareholders will probably include individual investors from within and outside the United States, corporations, tax-exempt entities such as universities, and partially tax-exempt entities such as pension funds. Those target shareholders that are taxable investors have different tax attributes, including different tax rates and/or the presence of capital loss carryforwards, and tax bases in the stock of the target, both of which could affect the price at which they are willing to sell their target stock. Tax-exempt entities may be willing to sell shares at a lower pretax cost than taxable shareholders, all other things being equal.

The precise effects of the various tax statuses of a target's shareholders on acquisitions prices are not well understood. It seems prudent, however, to consider these issues as part of an overall acquisition strategy.

A tax planner can obtain information about the shareholders of a target firm from several sources. Information about institutional owners of various types can be obtained from CDA/Spectrum. Spectrum produces a quarterly report for publicly traded target firms with information about current institutional ownership and any changes therein.<sup>24</sup> Time-series analysis of these data therefore can provide a potential acquirer with a reasonable estimate of the proportion of a target's stock that is held by institutions and their tax bases in the target's stock.

Analysis of target firm's financial disclosures, such as 10-Ks, can provide information about other large block holders of the target's stock. Various financial databases

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<sup>24</sup>Institutions covered by the report include mutual funds, corporations, and pension funds among several other types.

contain daily stock price and volume information for publicly traded firms. From these databases and assumptions about holding periods, potential acquirers can estimate an average shareholder tax basis in the stock of the target. The combination of these data sources provides tax planners with a reasonable first approximation of the tax liabilities or benefits (taxable losses) faced by target shareholders in a taxable acquisition.<sup>25</sup>

## Estimating the Net Tax Basis of a Target's Assets

Throughout our discussions we have assumed a value for the net tax basis of a target's assets. As you undoubtedly realize, however, this figure is a key variable in the acquisition structuring decision. How do we estimate the net tax basis of a target's assets?

A first approximation can be derived from the target's financial statements. As you know, we can use two significant differences between the tax-basis and financial accounting basis balance sheet to estimate the net tax basis of a target's assets. The deferred tax account represents differences in a target's book and tax asset basis that are caused by **temporary differences**, such as accelerated depreciation for tax and straight-line depreciation for book. The second major difference between the book and tax basis of a firm's assets is any so-called permanent differences. The most obvious example of a permanent difference is goodwill that is not tax deductible; that is, goodwill that is reported in the financial statements but does not appear on the tax-basis balance sheet.<sup>26</sup> It is also necessary to control for financial accounting assets, such as deferred tax assets, which are not recorded for tax purposes.

The net tax basis of a target's assets then can be computed as the financial accounting basis in the net assets adjusted for deferred tax items and permanent differences such as goodwill. The difference between the book and tax basis of a firm's assets associated with temporary differences is multiplied by the tax rate to arrive at the deferred tax amount presented in the financial accounting balance sheet. Therefore, the book/tax-basis difference arising from temporary differences can be computed by *dividing* financial accounting deferred taxes by the tax rate. Estimating the amount of goodwill that is not tax deductible is also not difficult if the firm's disclosures are relatively complete (see Section 13.6 of Chapter 13).

An estimate of the gross tax basis of a firm's assets is the gross financial accounting assets (total assets on the balance sheet) plus/minus timing differences and minus permanent differences. When actually estimating the net tax basis (gross assets less liabilities) of a firm's assets, we must also control for financial accounting liabilities that are not recorded for tax purposes. For example, a deferred tax liability on a firm's balance sheet is not a liability on the tax-basis balance sheet. Hence, when subtracting the firm's liabilities from gross tax assets, we should not include the deferred tax liability in the tax-based liability figure.

Figure 14.5 contains the 1999 and 2000 income statement, balance sheet, and tax footnote disclosures for Loreto, Inc. We have combined several balance sheet items

<sup>25</sup>These estimates can also provide tax planners with an estimate of the potential tax savings associated with tax deferral. Chapter 16 addresses this issue in detail.

<sup>26</sup>Recall that, in taxable stock acquisitions in which a Section 338 election is not made, the tax basis of the assets of the target carryover. Purchase accounting would result in financial accounting goodwill from a write-up in the assets for financial accounting while there is no step-up in the target's assets for tax purposes. Many freestanding companies previously acquired other companies and have goodwill that is not tax deductible on their balance sheets from these prior acquisitions.

**FIGURE 14.5** Financial Statements of Loreto, Inc.

<b>Loreto</b> <b>CONSOLIDATED STATEMENT OF INCOME</b> (in \$ millions)	<b>Year Ended December 31</b>	
	<b>2000</b>	<b>1999</b>
Service sales	\$5,204	\$2,398
Product sales	3,401	3,150
Sales of services and products	8,605	5,548
Cost of services sold	(3,015)	(1,412)
Cost of products sold	(2,853)	(2,434)
Costs of services and products sold	(5,868)	(3,846)
Restructuring, litigation, and other matters (notes 1, 17 and 20)	(979)	(319)
Marketing, administration, and general expenses	(2,406)	(1,323)
Operating profit (loss)	(648)	60
Other income and expenses, net (note 19)	(86)	137
Interest expense	(456)	(236)
Loss from Continuing Operations before income taxes and minority interest in income of consolidated subsidiaries	(1,190)	(39)
Income tax benefit (note 6)	423	6
Minority interest in income of consolidated subsidiaries	(6)	(11)
Loss from Continuing Operations	(773)	(44)
Discontinued Operations, net of income taxes	(57)	110
Estimated gain (loss) on disposal of Discontinued Operations	1,018	(76)
Income from Discontinued Operations	961	34
Extraordinary item: Loss on early extinguishment of debt	(93)	—
Net income (loss)	<u>\$95</u>	<u>(\$10)</u>

<b>Loreto</b> <b>CONSOLIDATED BALANCE SHEET</b> (in millions)	<b>Year Ended December 31</b>	
	<b>2000</b>	<b>1999</b>
<b>ASSETS:</b>		
Cash and cash equivalents (note 1)	\$220	\$196
Customer receivables (note 7)	1,561	1,431
Inventories (note 8)	783	730
Uncompleted contracts costs over related billings (note 8)	686	542
Program rights	431	301
Prepaid and other current assets	1,106	844
Total current assets	4,787	4,044
Plant and equipment, net (note 9)	1,866	1,908
FCC licenses, net (note 10)	1,240	1,586
Goodwill, net (note 2)	8,776	5,244
Deferred taxes (note 6)	3,220	3,758
Total assets	19,889	16,540
<b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>		
Short-term debt (note 11)	\$497	\$306
Current maturities of long-term debt (note 13)	4	330
Accounts payable	887	796
Uncompleted contracts billings over related costs (note 8)	334	318
Other current liabilities (note 12)	2,578	2,112
Total current liabilities	4,300	3,862

FIGURE 14.5 (contd.)

Long-term debt (note 13)	4,409	7,125
Deferred taxes (note 6)	1,809	1,527
Other noncurrent liabilities (note 14)	3,619	2,573
Total liabilities	14,137	15,087
<b>Shareholders' Equity (note 15):</b>		
Preferred stock	14	15
Common stock	609	426
Capital in excess of par value	5,376	1,847
Common stock held in treasury	(546)	(720)
Minimum pension liability adjustment (note 4)	(796)	(1,220)
Cumulative foreign currency translation adjustments	11	(11)
Retained earnings	1,084	1,116
Total shareholders' equity	\$5,752	\$1,453
Total liabilities and shareholders' equity	\$19,889	\$16,540

**Loreto****NOTES TO THE FINANCIAL STATEMENTS****NOTE 2: AMORTIZATION OF GOODWILL**

Goodwill is assigned a useful life of between 20 and 40 years and amortized using the straight-line method. Total goodwill amortization was \$150 in 1999 and \$270 in 2000.

**NOTE 6: INCOME TAXES****INCOME TAX EXPENSE (BENEFIT) FROM CONTINUING OPERATIONS (in millions)**

	2000	1999
<b>Current:</b>		
Federal	(\$653)	\$2
State	(116)	1
Foreign	32	22
Total current income tax expense (benefit)	(737)	25
<b>Deferred:</b>		
Federal	304	(43)
State	10	(4)
Foreign	—	16
Total deferred income tax expense (benefit)	314	(31)
Income tax benefit	(\$423)	(\$6)

Deferred income taxes result from temporary differences in the financial bases and tax bases of assets and liabilities. The types of differences that give rise to significant portions of deferred income tax liabilities or assets are shown in the following table:

**CONSOLIDATED DEFERRED INCOME TAXES BY SOURCE (in millions)**

	2000	1999
<b>Deferred tax assets:</b>		
Restructuring charges	\$1,352	\$1,133
Charges related to post-retirement benefits	1,868	2,625
Total deferred tax assets	3,220	3,758
<b>Deferred tax liabilities:</b>		
Accelerated depreciation and amortization	(1,809)	(1,527)
Total deferred tax liabilities	(1,809)	(1,527)
<b>Deferred income taxes, net asset</b>	\$1,411	\$2,231

FIGURE 14.5 (contd.)

RECONCILIATION OF INCOME TAX EXPENSE (BENEFIT)  
TO THE TAX EXPENSE (BENEFIT) BASED ON THE STATUTORY RATE

	2000	1999
Federal income tax benefit at statutory rate	(\$417)	(\$14)
<b>Increase (decrease) in tax resulting from:</b>		
Amortization of goodwill	46	21
State income tax, net of federal effect	(69)	(2)
Lower tax rate on income of foreign sales corporations	(9)	(3)
Lower tax rate on net income of Puerto Rican operations	(17)	(29)
Gain on sale of stock of subsidiary and affiliate	—	12
Loss of foreign tax credit	3	3
Foreign rate differential	(26)	(12)
Nondeductible expenses	8	6
Dividends from foreign investments	8	2
Other differences, net	50	(1)
<b>Income tax benefit from Continuing Operations</b>	<b><u>(\$423)</u></b>	<b><u>(\$6)</u></b>

from a large publicly traded firm's financial statements to create the data for Loreto, Inc. in order to simplify our estimate of net asset tax basis.

We can estimate the net tax basis of this firm's assets at year-end 2000 as illustrated in Table 14.4. We start with the gross financial accounting basis of this firm's assets (\$19,889) and subtract deferred tax assets of \$3,220. We subtract deferred tax assets because this balance sheet account is not recorded for tax purposes.

We next make two adjustments for differences in the tax and book basis of Loreto's assets arising from temporary differences. Deferred tax assets reflect deductions taken for book purposes that have not yet been taken for tax purposes, such as restructuring charges. Dividing the deferred tax asset amount on the balance sheet by the tax rate produces the difference in book and tax basis due to the deferred tax item. In this case, tax-basis assets are higher than book-basis assets by \$9,200.<sup>27</sup> A similar adjustment is made for deferred tax liabilities, although deferred tax liabilities reflect situations in which the tax asset basis is less than the financial accounting asset basis, as in accelerated depreciation. For this reason, we subtract the grossed-up deferred tax liability from financial accounting assets. In our example, the adjustment is \$5,169 for deferred tax liabilities.

Goodwill that is not tax deductible appears on the financial accounting balance sheet but not the tax-based balance sheet. As a result, we need to estimate the amount of goodwill that is not tax deductible. We explained the mechanics of this computation in Chapter 13. Table 14.4 illustrates once again how this computation is performed.<sup>28</sup>

<sup>27</sup>Loreto likely took a large restructuring charge in a prior period. This charge reduces financial accounting asset basis. Such a charge is not tax deductible and therefore did not reduce the tax basis of Loreto's assets.

<sup>28</sup>Under FAS 142, for acquisitions after June, 2001, acquirers must disclose the amount of goodwill created in the acquisition.

TABLE 14.4 Estimating the Tax Basis of a Firm's Assets

		<i>Year End 2000</i>
Gross financial accounting asset basis		\$19,889
<b>Less:</b>		
Deferred tax assets <sup>(1)</sup>		(\$3,220)
<b>Plus Deferred Tax Asset Adjustment:</b>		
Deferred tax assets	\$3,220	
Implied difference in book and tax basis due to deferred tax assets <sup>(2)</sup>		9,200
<b>Less Deferred Tax Liability Adjustment:</b>		
Deferred tax liabilities	(1,809)	
Implied difference in book and tax basis due to deferred tax liabilities <sup>(3)</sup>		(5,169)
<b>Less Goodwill That Is Not Tax Based:</b>		
Goodwill on the balance sheet	\$8,776	
Financial accounting goodwill amortization expense <sup>(4)</sup>	270	
Nondeductible amortization expense adjustment in the tax footnote <sup>(5)</sup>	46	
Estimated goodwill amortization expense that is not tax deductible <sup>(6)</sup>	131	
Percentage of goodwill that is not tax deductible <sup>(7)</sup>	48.68%	
Estimated balance sheet goodwill that is not tax deductible <sup>(8)</sup>		(\$4,272)
Estimated gross tax basis of the target's assets <sup>(9)</sup>		\$16,429
<b>Less Tax-Based Liabilities:</b>		
Financial accounting liabilities on the balance sheet	\$14,137	
Less: deferred tax liabilities <sup>(10)</sup>	(1,809)	
Tax liabilities		(12,328)
Net tax basis of the target's assets <sup>(11)</sup>		<u>\$4,101</u>

<sup>(1)</sup>Deferred tax assets are recorded for financial accounting purposes but not for tax purposes. Hence they are not tax-based assets.

<sup>(2)</sup>Deferred tax assets divided by the corporate tax rate. This estimate reflects the difference in the book and tax basis of the firm's assets arising from deferred tax assets (e.g., restructuring charges).

<sup>(3)</sup>Deferred tax liabilities divided by the corporate tax rate. This estimate reflects the difference in the book and tax basis of the firm's assets arising from deferred tax liabilities (e.g., accelerated depreciation).

<sup>(4)</sup>Per footnote #2 (see Figure 14.8).

<sup>(5)</sup>Per footnote #6 (see Figure 14.8).

<sup>(6)</sup><sup>(5)</sup>divided by the corporate tax rate. Amount reported in<sup>(5)</sup> is the increase in tax expense due to non-deductible goodwill amortization expense. Dividing by the tax rate produces the amount of expense claimed for book purposes that was not tax deductible.

<sup>(7)</sup><sup>(6)</sup>divided by<sup>(4)</sup>.

<sup>(8)</sup><sup>(7)</sup>multiplied by amount of goodwill on the balance sheet.

<sup>(9)</sup>Financial accounting total assets adjusted for deferred taxes, differences in book and tax basis arising from timing differences as manifested in deferred tax accounts and goodwill that is not tax deductible (not recorded on the tax-basis balance sheet).

<sup>(10)</sup>Deferred tax liabilities are not recorded on the tax-basis balance sheet and must be removed from financial accounting liabilities in order to estimate tax-based liabilities.

<sup>(11)</sup><sup>(9)</sup>less tax liabilities.

Using this approach, we estimate that nondeductible goodwill is \$4,272. Our estimate of the gross tax basis of Loreto's assets then is \$16,428.

Net tax basis can be estimated by subtracting tax-basis liabilities from the gross asset tax basis. Tax-basis liabilities are financial accounting liabilities less liabilities recorded for financial accounting purposes that are not recorded for tax purposes, as with deferred tax liabilities. We therefore subtract deferred tax liabilities from financial accounting liabilities to arrive at our estimate of tax-based liabilities of \$12,328. An estimate of Loreto, Inc.'s net asset tax basis, as of year-end 2000, shown in Table 14.4, is \$4,101—gross asset-basis less tax-basis liabilities.

Note that this technique provides a good first approximation, but that financial disclosures or lack thereof may result in substantial imprecision in estimates. Further, such approximations are difficult in multinational corporations.

### Summary of Key Points

1. Mergers and acquisitions occur across a number of transactional forms. These alternative forms yield varying tax consequences to the target company, to the purchasing company, and to the shareholders of the target company.
2. Mergers and acquisitions that allow the buyer to step up the basis of assets acquired typically result in a loss of the target's tax loss and tax credit carryforwards, as well as other tax attributes of the target company. Such transactions also subject the target company to ordinary and capital gains tax. An example of such a transaction is a sale of the target's assets followed by a liquidation of the target company.
3. When the stock of a freestanding C corporation is acquired, the buyer may elect under Section 338 to treat the transaction *as if* the target's assets had been acquired, followed by a liquidation of the target company.
4. Prior to TRA 86, a tax advantage resulted from effecting a step-up. Under the so-called General Utilities doctrine, the corporate-level capital gain associated with the step-up in the target's assets was nontaxable. After 1986, the capital gain on the asset sale is fully taxable.
5. In the sale of a freestanding C corporation, a structure that results in a step-up in the target's assets is usually suboptimal from a tax perspective because the incremental tax cost associated with the step-up usually exceeds the incremental tax benefits. The notable exception to this general rule occurs when the target has substantial NOLs, which can be used to reduce the incremental cost of the step-up.
6. Although a step-up in a target's assets doesn't occur frequently in sales of entire freestanding C corporations, in two types of transactions a step-up structure is common. In sales of subsidiaries of companies, transactions are often structured in a manner that results in a step-up in the tax basis of the target's assets. It is also common to structure the sale of a conduit entity such as an S corporation in a similar manner.
7. Substantial differences in terms of nontax implications separate selling a target's assets from selling a target's stock. In the former case, title transfer costs may be excessive, although nontax benefits from liability avoidance can accrue to acquirers. In the latter case, acquisition transaction costs are likely lower, and with this structure the acquirer may be able to obtain certain assets such as licenses that will not transfer in an asset sale. With a stock acquisition, the acquirer obtains all the assets and liabilities, including contingent liabilities, a potentially significant cost associated with a stock acquisition.



**Discussion Questions**

1. What are the main tax considerations in the sale of a target's stock to a purchaser?
2. What are the disadvantages of effecting a change in the basis of all the firm's assets either by their sale, followed by a complete liquidation, or by a stock purchase, along with an election to treat the stock purchase as a purchase of all the firm's assets followed by a liquidation?
3. Because a purchaser can use a target's NOL carryforwards to offset the ordinary and capital gain and recapture tax on the sale of the target's assets, it has been argued that this reduces the cost of achieving a stepped-up basis in assets and makes it advantageous for the purchaser to acquire the target. Do you agree with this argument?
4. What types of transactions generate tax-deductible goodwill? How many acquisitions of freestanding C corporations, as a general rule, give rise to tax-deductible goodwill?
5. As a financial analyst or tax planner, how would you determine whether a potential target firm's goodwill was tax-based goodwill (deductible)?
6. What are the nontax benefits, if any, of an asset acquisition? What are the nontax costs, if any, of an asset acquisition?
7. What are the nontax benefits, if any, of a stock acquisition? What are the nontax costs, if any, of a stock acquisition?

**Tax Planning Problems**

1. Consider the following facts in order to quantify the tax costs of various taxable acquisition structures when the target is a freestanding C corporation. Wolverine, Inc., wants to purchase Reel Deal, Inc., in a taxable acquisition. Reel Deal is a freestanding C corporation with a net asset tax basis of \$250. Reel Deal has no NOLs and is currently owned by five shareholders that have a basis in their Reel Deal stock of \$5. Wolverine is planning to offer \$10,000 for all of the assets of Reel Deal. The corporate tax rate is 40%, the after-tax discount rate is 15%, and the shareholder-level capital gains tax rate is 20%.
  - a. How much cash after tax will the shareholders of Reel Deal have in a taxable asset sale at a price of \$10,000?
  - b. What is Wolverine's net after-tax cost of this transaction assuming that any step-up in Reel Deal's assets are amortized/depreciated over 15 years straight-line, the appropriate corporate tax rate is 40%, and the after-tax discount rate is 15%?
  - c. What price could Wolverine pay for Reel Deal in a taxable stock acquisition without a Section 338 election? What would Wolverine's net after-tax cost of this structure be?
  - d. Given the price computed in part (c), what would *ADSP* be if Wolverine decided to make the Section 338 election? What would Wolverine's net after-tax cost be with this structure of a taxable stock sale with a Section 338 election?
  - e. Which structure should be used in this acquisition? Why?
2. Abaco is planning to acquire Cozumel Airlines, a freestanding C corporation, in expectation that new management can be brought in to achieve substantial operating efficiencies. You have been retained to advise Abaco on how to structure the acquisition.

Two graduate school friends, Monique and Denise, own Cozumel Airlines. Together, they have a \$1 million basis in their Cozumel Airlines stock. Both Monique and Denise have held their Cozumel Airlines stock for several years but must sell their stock for nontax reasons. Cozumel Airlines' tax-basis balance sheet contains \$14 million of assets, no liabilities, and no net operating loss carryovers. All parties

agree that Cozumel Airlines would be worth \$20 million to Abaco with no step-up in Cozumel's inside (asset) basis, but \$21.25 million if its inside (asset) basis was stepped up to fair market value. Monique and Denise each face a 40% tax rate on ordinary income and a 20% tax rate on capital gains. The corporate tax rate is 35%.

*Option 1:* Abaco buys outright all Cozumel Airlines' assets for \$18 million—a taxable asset acquisition. Cozumel Airlines pays resulting taxes on the sale, if any, and distributes the proceeds to Monique and Denise in a complete liquidation.

*Option 2:* Abaco pays Monique and Denise \$ \_\_\_\_ million in cash for their stock in Cozumel and **does not** make a Section 338 election.

- a. How much after-tax cash will Monique and Denise get in aggregate if Option 1 is chosen?
  - b. In Option 2, how much cash would Abaco have to pay to make Monique and Denise indifferent between Option 1 and Option 2?
  - c. What is Abaco's net present value if Option 1 is chosen?
  - d. What is Abaco's net present value if Option 2 is chosen—based on your answer to part (b)?
3. Walkers is planning to acquire Cayman Bank, a freestanding C corporation, in expectation that new management can be brought in to achieve substantial operating efficiencies. You have been retained to advise Walkers on how to structure the acquisition.

Two grad school friends, Joe and Jim, own Cayman Bank. Together, Joe and Jim have a \$6 million basis in their Cayman Bank stock. Both Joe and Jim have held their Cayman Bank stock long enough to get long-term capital gain treatment but must sell their stock for nontax reasons. Cayman Bank's tax-basis balance sheet contains \$3.5 million of assets, no liabilities, and \$2.5 million of net operating loss carryovers. All parties agree that Cayman Bank would be worth \$8 million to Walkers with no step-up in Cayman's inside (asset) basis, but would be worth \$8.75 million if its inside (asset) basis was stepped up to fair market value. Joe and Jim each face a 40% tax rate on ordinary income and a 20% tax rate on capital gains. The corporate tax rate is 35%.

*Option 1:* Walkers buys outright all of Cayman Bank's assets for \$7 million in a taxable asset acquisition. Cayman Bank pays resulting taxes on the sale, if any, and distributes the proceeds to Joe and Jim in a complete liquidation.

*Option 2:* Walkers pays Joe and Jim \$ \_\_\_\_ million in cash for their stock in Cayman and **does not** make a Section 338 election.

- a. How much after-tax cash will Joe and Jim get in aggregate if Option 1 is chosen?
- b. In Option 2, how much cash would Walkers have to pay to make Joe and Jim indifferent between Option 1 and Option 2?
- c. What is Walkers' net present value if Option 1 is chosen?
- d. What is Walkers' net present value if Option 2 is chosen, based on your answer to part (b)?
- e. Which structure is optimal? Why?

## References and Additional Readings

See list at the end of Chapter 13.

- 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.