

Online Class # 5 / Week # 5:

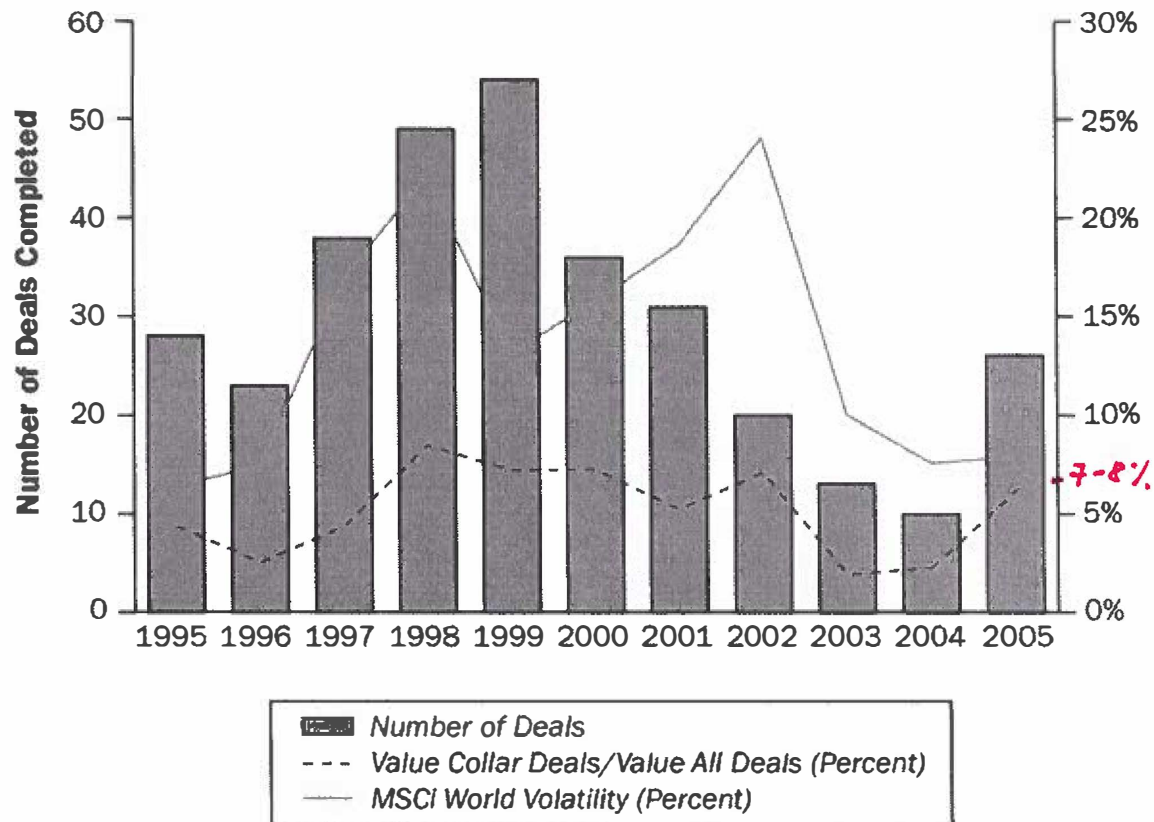
✓ Tax Issues in M&A

✓ Accounting for M&A

– Midterm to be graded by 11/28

Exhibit 1

Collar Incidence and Share in Global M&A Deals



Source: Securities Data Company, FactSet

To be updated by Q1 2021

Escrow Agreement in Private Target Purchase

$$\text{EBITDA} = 1 \text{m \$}$$

$$10 \times \text{EBITDA} = \text{Purchase Price} = \$10 \text{m}$$

→ Usually 12% deposited in escrow for
18 months

\$1.2m for 18 months

→ Reasons for the escrow agreement

✓ Seller

- Joint & several liability
- ✓ 60%, 10%, 10%, 20%
- ✓ Traded w/ a cap agreements
- ✓ Higher price

✓ Buyer

- ✓ Recourse
- ✓ Saves on due diligence
(time)

Economic rationale behind use of escrow agreements in private target acquisitions

Escrow agreements are more frequently used in private target acquisitions if:

1. It is more important for the bidder to *manage acquisition-related transaction risk*. Use is more common in subsidiary versus private stand-alone firm acquisitions. In the case of subsidiary acquisitions, a bidder would have legal recourse post-deal closure against both the parent firm that sold the subsidiary and the principal shareholders of the parent firm, while for private firm acquisitions the bidder would only have recourse against the principal shareholders of the target. Escrow contracts are used in 65% of private firm acquisitions, but these contracts are used in only 32% of subsidiary acquisitions.
2. There is *more information asymmetry* about the target's value the bidder faces greater transaction risk, in these instances the benefits to using an escrow contract should be larger. Whether an escrow contract is used in the context of the acquisition of an unlisted target is positively associated with: (1) earnings volatility in the target's industry, (2) if there is a smaller number of analysts covering the target's industry, (3) if the target operates in a different industry than does the bidder, (4) the target's total accruals, and (5) if a target's interest coverage ratio is low.
3. When there is high *target-side acquisition-related transaction risk*. When a target has a dominant shareholder, defined as a shareholder who owns at least 20 percent of the target's shares but not all of its shares, an escrow contract can be particularly useful to manage this shareholder's transaction risk. If such a contract is in place all target shareholders would bear pro rata costs of bidder recourse actions subsequent to an acquisition. In contrast, if such a contract is not in place in most cases bidder recourse actions subsequent to an acquisition would result in the target's dominant shareholder being held liable and sued by the bidder.¹
4. In acquisitions where due diligence costs are large relative to deal value due to significant information asymmetry about the target's value. The use of an escrow contract is expected to reduce a bidder's need to incur significant due diligence costs in these deals.

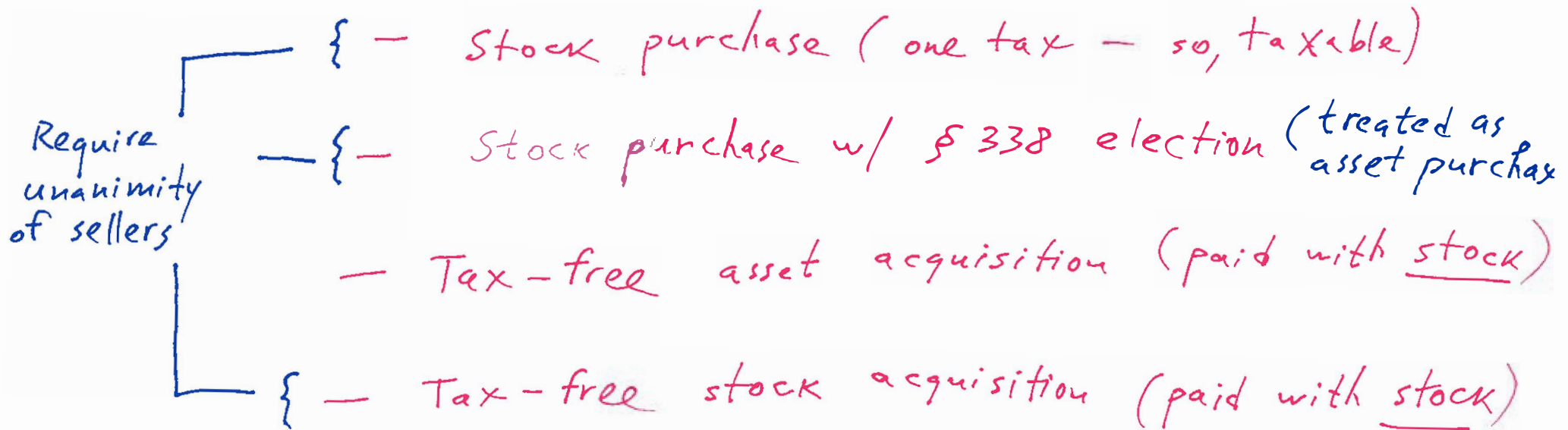
	Unlisted targets	Unlisted targets with escrow contract (52% of all)	Unlisted targets w/out escrow contract
Percent of deals that are <u>stock</u> purchase transactions	73.7%	80.0%	66.8%
Percent of deals that are <u>asset</u> purchase transactions	26.3%	20.0%	33.2%
Percent of deals for stand-alone private firm targets	40.3%	75.6%	43.8%
Percent of deals for subsidiary targets	39.7%	24.4%	56.2%
✓ Percent of deals with a dominant target shareholder	36.8%	48.3%	24.1%
✓ Percent of deals with a <u>liability cap</u>	73.7%	85.3%	61.1%

¹ In such cases, the dominant shareholder could then sue smaller shareholders to recover some of their share of the sale proceeds. However, given that these recourse lawsuits are costly, the use of an escrow contract would be a more efficient way for the dominant shareholder to manage acquisition-related transaction risk.

Tax Issues

Ways to Buy :

— Asset purchase (taxable — twice!)





Ways to Sell:

✓ Divestiture  338(h)(10) election

✓ Spin-off (stock dividend plan)

✓ Equity carve-out (< 20%)

 IPO for subsidiary stock

 Direct sale of stock of subsidiary by parent

✓ Liquidate

Ways to Sell:

Divestiture: sale of a group of operating assets for \$ or some other property (a subsidiary, business segment) in a stock purchase

→ if buyer buys ^{the} divested ^{company} stock ⇒ and declares §338, treated as asset purchase w/ double taxation

→ can avoid it by election to §338(h)(10):

- Acquirer purchase of Target stock ignored;
- "New Target" treated as purchasing "old Target" assets
- "Old Target" treated as selling assets to "New Target"
- "Old Target" treated as then having liquidated into parent (owned 80% or more) in tax-free §332 liquidation
- Parent (i.e., target's parent) inherits "Old Target" tax attributes

Now, why would Target's parent agree to this election?

* The election will reduce target's parent taxable gain if its stock basis in target shares < target's asset basis in its assets

Other ways to sell:

- Equity carve-out → sale of a portion of the stock of its subsidiary in an IPO
 - usually one sells $< 20\%$
 - parent can sell directly the stock or subsidiary can do the IPO (in the latter case \$ can go back to parent via tax-free dividend b/c subsidiary still consolidates)
- Spin-Off: ✓ distribution by company of stock of subsidiary ($\geq 80\%$) as a dividend
 - ✓ Parent must not have acquired subsidiary in the past 5 years
- Liquidation: eliminates double taxation!
Capital gain (or loss) = cash + FMV property — Basis of Stock (for shareholders)

- ✓ Avoids double taxation
- ✓ Requires agreement by both buyer & seller

§ 338(h)(10) Election

Used on stock sales by S corp & sales of subsidiaries in consolidated group

Built-in-Gains Tax

- ✓ Important: @ 21 % and incremental to other tax (top corporate income tax)
- ✓ Levied upon conversion of C-corp to S-corp
- ✓ Equals 21 % of $(\text{FMV at time of conversion} - \text{Tax Basis of Assets})$

↓

ALL ASSETS!
- ✓ Mandated 5 year post-conversion recognition period → can wait past year 5 to sell asset

Taxable M&A

Tax Issues in M&A

Reverse Triangular Merger vs. Forward Triangular Merger

treated as stock purchase

treated as asset purchase

Ways to buy:

Taxable {

- Asset purchase
- Stock purchase w/ §338 election
- stock purchase w/out §338 Election

Tax-Free {

- Asset Acquisition
- stock Acquisition

Ways to sell:

divestiture {

- Subsidiary Stock Sale
- Subsidiary Asset Sale

Spin-off (pro-rata share distribution to S.H.) → only if sub is consolidated @ parent owns ≥ 80% stock

Equity Carve-Out (parent retains control) (up to 20% of subsidiary stock)

can also declare §338(h)(10) election

$$\begin{array}{c}
 ? \\
 \text{ADSP} \\
 \hline
 1000
 \end{array}
 =
 685 + \cancel{0} + \overbrace{.35 (\text{ADSP} - 100)}^{\text{New Liability to IRS}}$$

1000

Comparison of Taxable Acquisitions

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 =	\$1,000.00
Target's net asset basis	\$100.00
Target shareholder's stock basis	\$100.00 ✓
$t_c =$	35%
$t_{eg} =$	20%
$r =$	10%
Amortization/depreciation period (n) =	10

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

$$ADSP = \text{Purchase Price} + \text{Liab.} + \text{Tax} * (ADSP - \text{Basis})$$

Case 3: Stock Purchase Followed by
338 Election

$$ADSP = \overset{1000}{\boxed{\overset{685}{P.P.} + \overset{\emptyset}{Liabilities}}}$$

Purchase
Price to
Equity Holders

$$+ \underset{.35}{Tax} * (\overset{1000}{ADSP} - \underset{100}{Basis})$$

Can solve this
valuation equation
for ADSP \Rightarrow

$$ADSP = 1,000 \$, \text{ now let's check:}$$

$$ADSP = 685$$

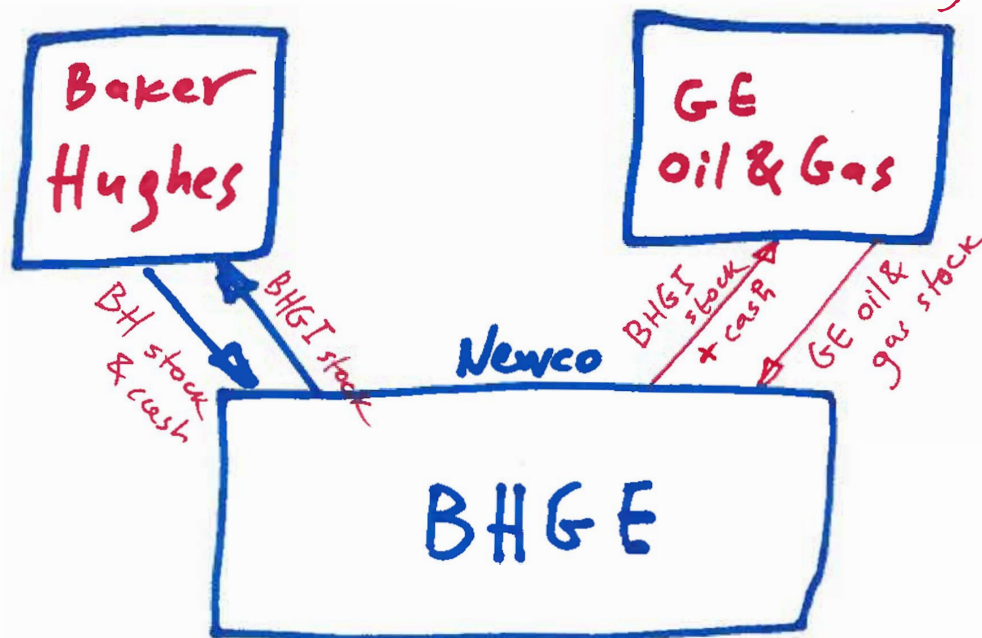
Tax-free Mergers

I.R.C. § 368 (a)(1)(A) "tax free merger" ("A Reorganization")

I.R.C. § 368 (a)(1)(B) "stock-for-stock exchange" ("B Reorg")
or a.k.a. creeping acquisition

I.R.C. § 368 (a)(1)(C) "stock-for-asset" merger ("C Reorg")

Tax free merger under I.R.C. § 351
(for example GE & BH)
merger



Tax-free acquisitions of C corp.: tax issues

TABLE 16.2 Comparison of Tax Implications of Tax-Free Acquisitions of Freestanding C Corporation

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					
	\$368 "A"	Creeping Acquisition \$368 "B"	\$568 "C"	\$351	
Purchase Price	\$685.00	\$685.00	\$685.00	\$685.00	
Cash	40% 274.00	0% 0.00	20% 137.00	60% 411.00	
Stock	411.00	685.00	548.00	274.00	
Target corporation tax liability	0.00	0.00	0.00	0.00	
Target shareholder gain recognized	274.00	0.00	137.00	411.00	
Target shareholder tax liability (20%)	54.80	0.00	27.40	82.20	
Target Shareholder After-Tax Wealth:	20% of 274.00				
Cash	\$219.20	\$0.00	\$109.60	\$328.80	
Stock	411.00	685.00	548.00	274.00	
Total	\$630.20	\$685.00	\$657.60	\$602.80	
Acquirer Net After-Tax Cost:					
Pretax cost	\$685.00	\$685.00	\$685.00	\$685.00	
Less: incremental tax savings	0.00	0.00	0.00	0.00	
Net after-tax cost	\$685.00	\$685.00	\$685.00	\$685.00	

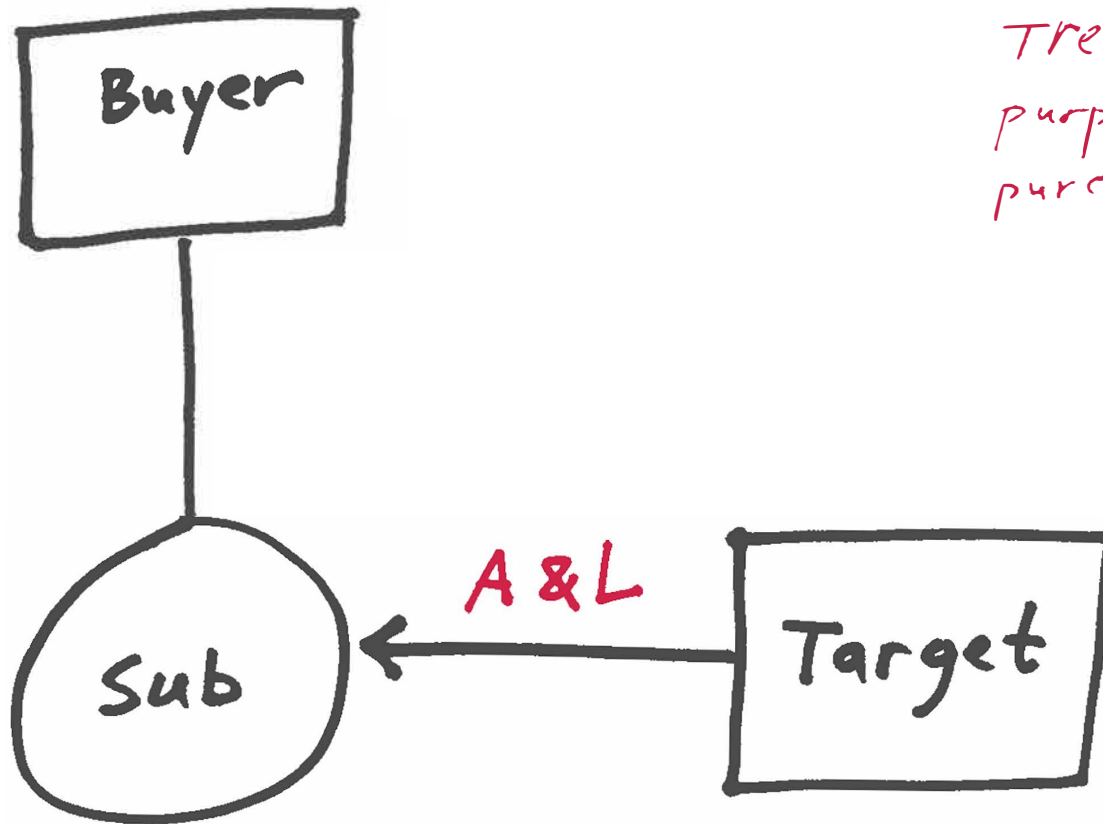
Lesser of gain
or cash
received

20% of
\$411.

lowest value
to target
S.H. however
permits to
distribute
up to 60%
in cash!

Reverse Triangular Merger

Treated for tax purposes as stock purchase

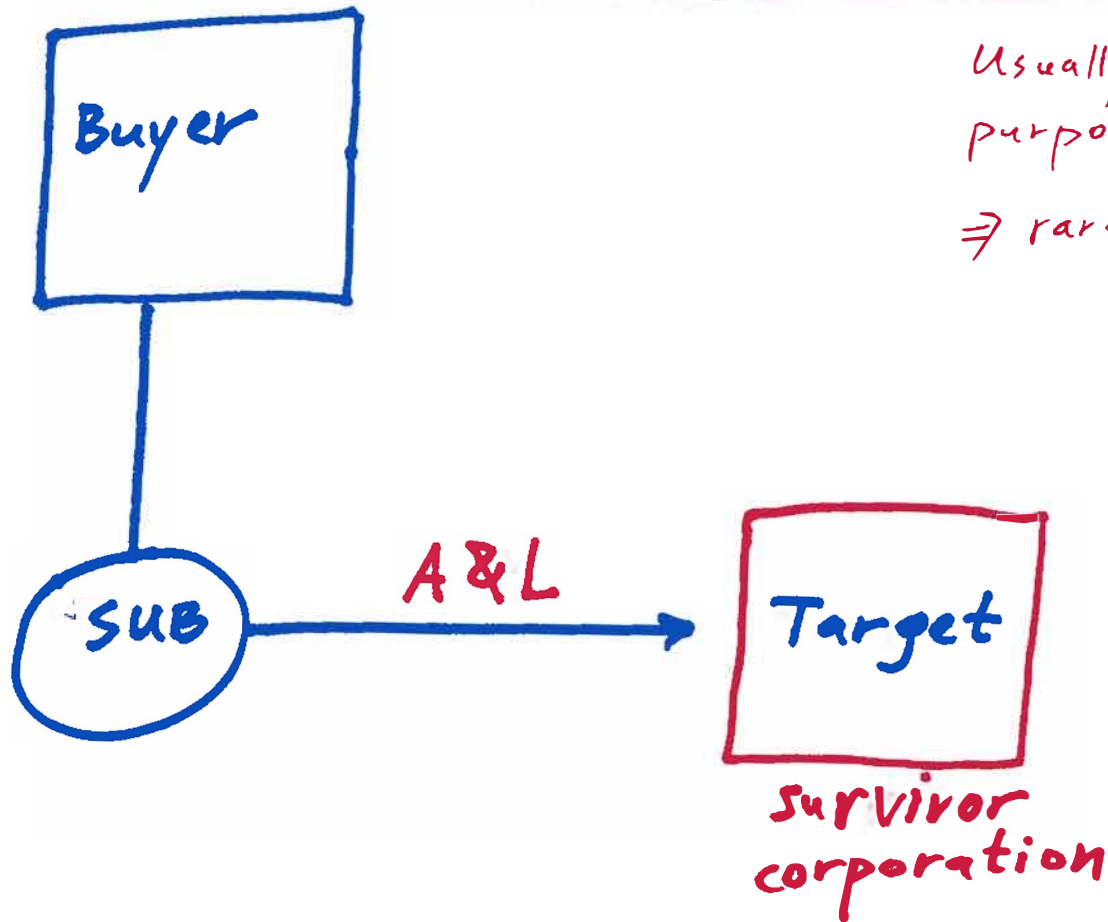


Survivor
Corporation

- If executed in the format of §368(A) of I.R.C. code ⇒
✓ tax-free merger
- ✓ most common merger format

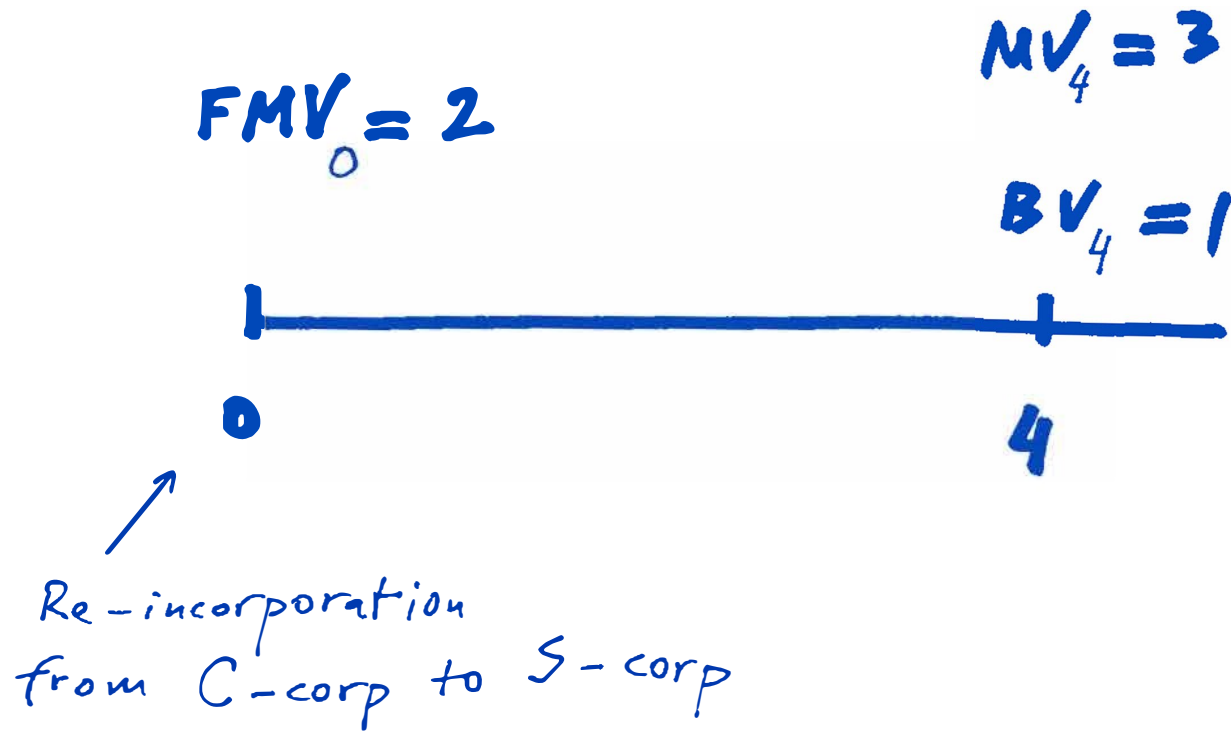
Forward Triangular Merger

Usually treated for tax purposes as asset purchase
⇒ rarely seen



Built-In-Gains Tax

Built-in Gains Example: Taxation



- Cap. gains tax on $(MV - BV)$
- If sale w/in first five years after conversion to S-corp \Rightarrow B.I.G. (built-in-gains) tax also on $(FMV_0 - BV_4)$

However, if no recorded $FMV_0 \Rightarrow$

B.I.G. tax applies on $(MV_4 - BV_4)$!

Advisable to have appraisal @ time zero!

Illustration of Calculation of Built-in-Gains (B.I.G.) Tax

Under the *Protecting Americans from Tax Hikes Act* (PATH Act), the built-in gains tax can apply for up to five years after conversion to an S corporation. That is, for each of the five years after a corporation elects S status, it is possible that the tax could apply when built-in gain property is sold or deferred taxable income is recognized.

Suppose a business that was previously a C corporation owns real estate that has appreciated and a favorable offer arrives in year #4 after the entity's conversion to S corporation status. The owner of said corporation should consider whether the property should be sold now or after the statutory fifth year passes to avoid double taxation. Let us assume said building had tax basis and book value of \$1 million (as of today, i.e., year #4 after conversion to C corporation status), at time of conversion to S corporation had fair market value (FMV) = \$2 million and upon sale today (i.e., in year #4), the market value is \$3 million.
 need to know it in order to minimize BIG

The asset sale will be accompanied by an incremental 21% built-in-gains tax, per I.R.C. code. *The excess of the FMV of assets over their asset basis at the time of the S election is the built-in gain subject to the incremental B.I.G. tax (21%).* How to calculate it?

If there are no offsetting tax credits, such sale will result in incremental B.I.G. tax bill of $21\% \times (\$2 \text{ million} - \$1 \text{ million}) = \underline{\$210,000}$ and an additional capital gains tax (for selling S corporation shareholders) of $20\% + 3.8\%$ (the latter is the net investment income tax of 3.8% for investment income above a certain threshold¹) on the difference between the market price net of the built-in-gains tax and net of the stock basis in the corporation (latter assumed to be \$1 million as well):

married filer threshold *BV* *BIG*

$$\text{Capital Gains Tax} = 20\% \times \underline{\$250,000} + 23.8\% \times (\$3 \text{ million} - \$1 \text{ million} - \underline{\$210,000} - \$250,000) = \$50,000 + \$366,520 = \$416,520.$$

= 20% capital gains + 3.8% net investment income tax

The total tax bill is therefore $\$210,000 + \$416,520 = \underline{\$626,520}$.
 (to fund Affordable Care Act)

By comparison, if the sale was effectuated at the end of year #5 for the same price (net of depreciation), there will be no B.I.G. tax and shareholders will pay capital gains tax of

assuming the same net sale price

$$20\% \times \$250,000 + 23.8\% \times (\$3 \text{ million} - \$1 \text{ million} - \$250,000) = \$50,000 + 416,500 = \underline{\$466,500} \text{ in tax.}$$

The saving will be $\underline{\$160,020} = \$626,520 - \$466,500$ for waiting one year, assuming sale price remains unchanged at \$3 million (net of depreciation). If however the sale price declines by more than the tax savings of \$160,020, it might make sense to sell in year #4.

The Importance of Appraisal

It is essential upon date of S corporation election (& conversion from C-corporation) to make an appraisal to determine the fair market value (FMV) of all assets. Why? Absent appraisal, the entire difference between asset basis and the sale price will be subject to the B.I.G. tax and to the capital gains tax!

¹ Current threshold for a single filer is \$200,000 of investment income, and \$250,000 for a married filer. Note that the net Investment income tax does not apply for changes in the value of certain – actively managed assets – such as working capital.

Purchase Accounting Method

Purchase Accounting Method

FASB 141, 142

(2001 implementation)

- Purchase price
- FMV
- Book values

} For the ^{assets} _{liab} / or shares /
of the target

✓ Goodwill impairment testing

||
Purchase price - FMV (acquired assets)

Pooling of Interest Method

Methods in Purchase Accounting

- 100% Target stock acquisition
- ✓ — Consolidation (if % Target shares acquired $> 50\%$)
- Equity method (if % Target shares acquired $> 20\% \& < 50\%$)
 - * "Investment into a target company"
- Cost Method (if % target shares acquired $< 20\%$)

Accounting Treatment: Consolidation

- Buyer acquires 60% assets & liabilities of Target

Partial Acquisition Purchase Accounting

Percentage of Target Acquired by Buyer	60%
Price Paid	\$ 6,000

	Company B
Enterprise Value Target	\$ 10,000
FMV Identifiable Assets Target	\$ 9,000
Carrying (Book) Value Assets Target	\$ 8,000

	Buyer B/S		
	Before	Transaction Adjustment	After
<u>Assets</u>			
Cash	\$ 6,000	\$ (6,000)	\$ -
Identifiable Assets	\$ -	\$ 9,000	\$ 9,000
Goodwill	\$ -	\$ 1,000	\$ 1,000
Total Assets	\$ 6,000	\$ 4,000	\$ 10,000
<u>Liabilities</u>			
Minority Interest	\$ -	\$ 4,000	\$ 4,000
Shareholder's Equity	\$ 6,000	\$ -	\$ 6,000
Total	\$ 6,000	\$ 4,000	\$ 10,000

To reflect the consolidation of 100% of the asset

Methods of Purchase Accounting

- 100% T stock acquisition

- Inventories
- A/R
- Fixed Assets
- Goodwill
- Liabilities

*Demonstrated @ beginning of topic example
(line-by-line addition)*

** note we netted out the accumulated depreciation for (i) buildings & (ii) equipment for the assets of the target*

- Partial T stock acquisition

- Consolidation method
 - Example



Method	Ownership (%)	Control
CONSOLIDATION	> 50%	Majority voting
EQUITY	20% to 50%	Material voting power
COST	< 20%	Some voting power

- Equity method

- “Investment in Target Company” →
- At cost of purchasing shares

- Cost method (investment @ affiliate – at acquisition cost)

Goodwill Impairment

Goodwill Impairment Testing Times

- Goodwill tested annually unless circumstances warrant timely test
if circumstances warrant it →
- Circumstances Examples (SFAS 142)
 - Significant adverse change in legal factors of business climate
 - Unanticipated competition
 - Loss of key personnel
 - Likely expectation reporting unit (or significant portion of) will be sold/ disposed of*then do the testing*
- Recoverability/fair value test approach: two-step process to identify impairments & record decreases in PP&E value
 - Impairment loss exists if **sum estimated future asset CF < book value**
 - Impairment measured as difference b/n book value & fair value (sum of discounted future cash flows)

Excel Example

\$ 2,000,000 → target stock payment
\$ 946,000 → liab. assumed

Purchase Price { 2,946,000



Assets Allocation:

1,875,000	Fixed Assets
500,000	Intangible Assets
100,000	Current Assets
471,000	→ Goodwill

EPS Dilution/ Accretion in M&A

- Allocation to purchase price
 - Goodwill minimization (CF strategy) vs. Goodwill maximization (EPS strategy)
 - Some buyers seek to allocate as much as possible of purchase price to fixed assets that are depreciated & intangible assets that are amortized, which provides extra tax shields (low EPS)
 - Others prefer to increase the goodwill (in particular if they are confident that impairment is unlikely). This strategy lowers depreciation & amortization, & leads to higher reported earnings
 - Form of financing & EPS
 - Payments with stock (as opposed to cash financed w/ debt) typically worsen EPS leading to higher earning dilution
- stock - for - stock → causes more dilution!
(see example from class)*

Impact of financing on EPS

→ stock-for-stock → more dilution
Example-in-class: $EPS_{-1} = .15\$ \rightarrow EPS_0 = .12\$$ (EPS ↓)

→ cash-for-stock → less dilution
(possibly accretion)

depending on interest
rate on the loan to fund
cash purchase

Example-in-class:

$$EPS_{-1} = .15\$ \xrightarrow{r_D = 10\%} EPS_0 = .118\$$$

$$EPS_{-1} = .15\$ \xrightarrow{r_D = 6\%} EPS_0 = .238\$$$

Cash-for-Stock Purchase Accounting

BUYER

CASH-FOR-STOCK, FUNDED WITH DEBT

Line	HISTORICAL			2003, PRO-FORMA		FORECASTED			
	2001	2002	2003	Entries	New Balance	2004	2005	2006	
1 Current Assets	\$ 86.4	\$ 90.7	\$ 95.2	\$ 100.0	<i>a</i>	\$ 195.2	\$ 200.0	\$ 225.0	\$ 254.3
2 Gross Fixed Assets	1,295.8	1,360.5	1,428.6	1,875.0	<i>b</i>	3,303.6	3,000.0	3,375.0	3,813.8
3 Accumulated Depreciation	(85.5)	(153.6)	(225.0)			(225.0)	(390.2)	(540.2)	(708.9)
Intangible Assets	-	-	-	500.0	<i>c</i>	500.0	428.6	357.1	285.7
4 Goodwill	-	-	-	471.3	<i>d</i>	471.3	471.3	471.3	471.3
5 Assets	1,296.6	1,297.7	1,298.8	2,946.3		4,245.1	3,709.7	3,888.3	4,116.1
6 Current Liabilities	43.2	45.4	47.6	41.7	<i>e</i>	89.3	100.0	112.5	127.1
7 Debt	900.7	768.9	619.2	2,904.7	<i>f</i>	3,523.9	2,808.2	2,731.0	2,636.2
8 Equity	352.7	483.4	632.0	-	<i>g</i>	632.0	801.5	1,044.8	1,352.7
9 Liabilities & Equity	1,296.6	1,297.7	1,298.8	2,946.3		4,245.1	3,709.7	3,888.3	4,116.1
10 Revenues	1,727.7	1,814.1	1,904.8	1,666.7	<i>h</i>	3,571.4	4,000.0	4,500.0	5,085.0
11 Cost of Materials & Labor	(1,382.1)	(1,451.2)	(1,523.8)	(1,333.3)	<i>i</i>	(2,857.1)	(3,200.0)	(3,600.0)	(4,068.0)
12 Depreciation	(64.8)	(68.0)	(71.4)	(93.8)	<i>j</i>	(165.2)	(165.2)	(150.0)	(168.8)
13 Synergies	-	-	-	-		-	-	-	-
14 Amortization of Intangibles	-	-	-	-	<i>k</i>	-	(71.4)	(71.4)	(71.4)
15 Goodwill Impairment	-	-	-	-	<i>l</i>	-	-	-	-
16 Interest Expense	(90.1)	(76.9)	(61.9)	(290.5)	<i>n</i>	(352.4)	(280.8)	(273.1)	(263.6)
17 Profit Before Taxes	190.7	217.9	247.6			196.7	282.6	405.5	513.2
18 Taxes @ 40%	(76.3)	(87.2)	(99.0)			(78.7)	(113.0)	(162.2)	(205.3)
19 Net Profit	\$ 114.4	\$ 130.7	\$ 148.6			\$ 118.0	\$ 169.5	\$ 243.3	\$ 307.9
20 Number of Shares	1,000	1,000	1,000	-	<i>m</i>	1,000	1,000	1,000	1,000

(accretion!) if $r_D = \phi \Rightarrow$
 $EPS = .238\#$

$EPS = .148$
 $-1\#$

assumes new
 debt \$2,000 funded @ 10%

$EPS = .118\#$

But, what if
 new debt @

Stock-for-Stock Purchase Accounting

BUYER

STOCK-FOR-STOCK

Line	HISTORICAL			2003 PRO-FORMA		FORECASTED		
	2001	2002	2003	Entries	New Balance	2004	2005	2006
1 Current Assets	\$ 86.4	\$ 90.7	\$ 95.2	\$ 100.0 <i>a</i>	\$ 195.2	\$ 200.0	\$ 225.0	\$ 254.3
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7 Debt	900.7	768.9	619.2	904.7 <i>f</i>	1,523.9	680.5	467.5	228.3
8 Equity	352.7	483.4	632.0	2,000.0 <i>g</i>	2,632.0	2,929.2	3,308.3	3,760.7
9 Liabilities & Equity	1,296.6	1,297.7	1,298.8	2,946.3	4,245.1	3,709.7	3,888.3	4,116.1
10 Revenues	1,727.7	1,814.1	1,904.8	1,666.7 <i>h</i>	3,571.4	4,000.0	4,500.0	5,085.0
11 Cost of Materials & Labor	(1,382.1)	(1,451.2)	(1,523.8)	(1,333.3) <i>i</i>	(2,857.1)	(3,200.0)	(3,600.0)	(4,068.0)
12 Depreciation	(64.8)	(68.0)	(71.4)	(93.8) <i>j</i>	(165.2)	(165.2)	(150.0)	(168.8)
13 Synergies	-	-	-	-	-	-	-	-
14 Amortization of Intangibles	-	-	-	- <i>k</i>	-	(71.4)	(71.4)	(71.4)
15 Goodwill Impairment	-	-	-	- <i>l</i>	-	-	-	-
16 Interest Expense	(90.1)	(76.9)	(61.9)	(90.5)	(152.4)	(68.1)	(46.8)	(22.8)
17 Profit Before Taxes	190.7	217.9	247.6		396.7	495.3	631.8	754.0
18 Taxes @ 40%	(76.3)	(87.2)	(99.0)		(158.7)	(198.1)	(252.7)	(301.6)
19 Net Profit	\$ 114.4	\$ 130.7	\$ 148.6		\$ 238.0	\$ 297.2	\$ 379.1	\$ 452.4
20 Number of Shares	1,000	1,000	1,000	1,000 <i>m</i>	2,000	2,000	2,000	2,000

$$EPS_1 = .148\#$$

$$EPS_0 = .119$$

✓ explanation of depreciation cost adj. in
the cash-for-stock purchase accounting example
merger

Note that the cash-for-stock vs. stock-for-stock
do not differ in the way they adjust the
accumulated depreciation!

Purchase Price Allocation

An example:

FASB 141 Purchase Price Allocation: An Example

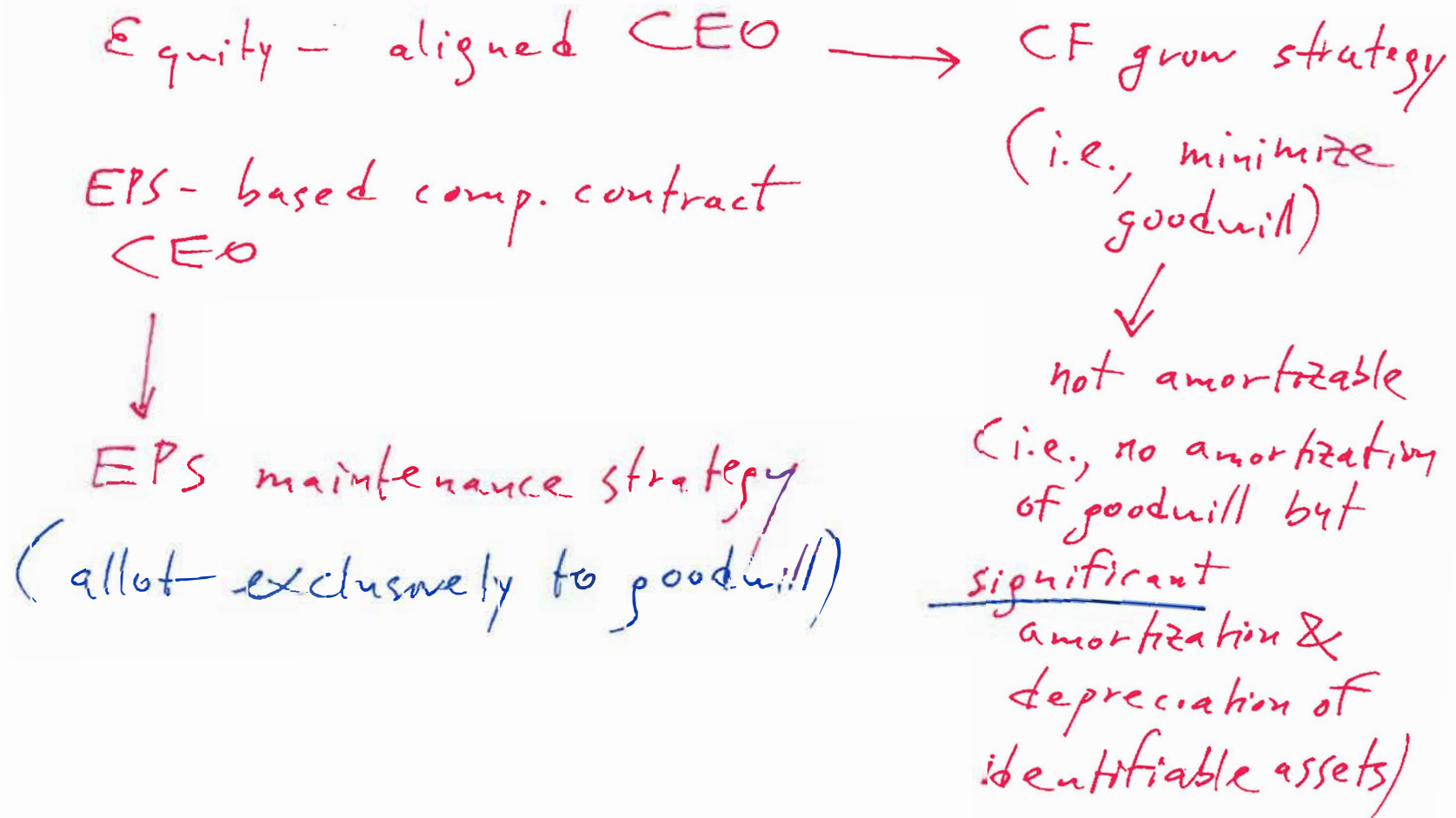
	Acquirer	Target		Merged Firm	Purchase Price
	BOOK VALUE	BOOK VALUE	FAIR VALUE		FAIR VALUE
Cash & receivables	\$ 250,000	\$ 180,000	\$ 170,000	\$ 420,000	\$ 170,000
Inventories	260,000	116,000	146,000	406,000	146,000
Land	600,000	120,000	400,000	1,000,000	400,000
Buildings	800,000	1,000,000	1,600,000	1,800,000	1,600,000
Accumulated depreciation-Bldgs.	(300,000)	(400,000)	(600,000)	(300,000)	(600,000)
Equipment	180,000	120,000	140,000	240,000	140,000
Accumulated depreciation-Equip.	(90,000)	(40,000)	(80,000)	(90,000)	(80,000)
Technology patents			15,000	15,000	15,000
Trademarks			17,000	17,000	17,000
Copyrights			10,000	10,000	10,000
Customer list			13,000	13,000	13,000
Favorable lease			28,000	28,000	28,000
Non-compete agreement			17,000	17,000	17,000
Goodwill			45,179	45,179	45,179
Total Assets	\$ 1,700,000	\$ 1,096,000	\$ 1,921,179	\$ 3,621,179	

Identifiable Intangible Assets

Intangibles that Meet Recognition Criteria

Marketing-Related	Customer-Related	Artistic-Related	Contract-Based	Technology-Based
<i>Trademarks, trade names</i> ✓	<i>Customer lists.</i> ✓	<i>Plays, operas, ballets</i>	<i>Licensing, Royalty, standstill agreements</i>	<i>Patented technologies</i> ✓
<i>Service marks, collective marks, certification marks</i>	<i>Order or production backlogs.</i>	<i>Books, magazines, newspapers</i>	<i>Advertising, construction, management, service, or supply contracts</i>	<i>Computer Software & Mask Work</i>
<i>Trade dress (unique color, shape, design)</i>	<i>Customer contracts & related customer relationships</i> ✓	<i>Musical composition</i>	<i>Lease Agreements</i> ✓	<i>Unpatented Technologies</i> ✓
<i>Newspaper masthead</i>	<i>Non-contractual customer relationships</i>	<i>Pictures, photographs</i>	<i>Construction Permits</i>	<i>Databases</i>
<i>Internet Domain Name</i>		<i>Motion pictures, music videos, TV programs</i>	<i>Franchise Agreements</i>	<i>Trade Secrets</i> ← <i>How can a trade secret be defined??</i>
<i>Noncompetition agreements</i> ✓			<i>Operating & Broadcasting Rights</i>	

EPS Dilution vs. Accretion



Make-up Quiz #5 (Week #5) for EMAD 5442

Question #1 (1 pts)

The tax treatment of purchase price allocation to a consulting agreement in an acquisition results in:

- A. Amortization allowances for the buyer & ordinary income taxation for the seller
- ✓ B. Current deduction for the buyer & ordinary income taxation for the seller
- C. Amortization allowances for the buyer & capital gains taxation for the seller
- D. Current deduction for the buyer & capital gains taxation for the seller

Question #2 (0.5 pts)

Decreasing the goodwill allocation (i.e., a cash flow maximization strategy) in an acquisition will decrease net income and maximize cash flows as it increases the allocation to other assets which in turn will increase the depreciation/ amortization allowances created by those assets.

- ✓ A. True
- B. False

Question #3 (0.5 pts)

Goodwill impairment loss is recorded if the carrying value of goodwill at the reporting unit is greater than the fair market value of said goodwill.

- ✓ A. True
- B. False

Question #4 (1 pts)

The recognized gain in Reorganizations 368 "A", "B" and "C" is equal to:

- ✓ A. The lesser of the realized gain and the cash received
- B. The greater of the realized gain and the cash received
- C. The realized gain
- D. None of the above

✓ Question #5 (0.5 pts)

Depreciation recapture is calculated as:

- ✓ A. The lesser of realized taxable gain and accumulated depreciation.
- B. The greater of realized taxable gain and accumulated depreciation.
- C. The lesser of unrealized gain and accumulated depreciation.
- D. The greater of unrealized gain and accumulated depreciation.

Question #6 (0.5 pts)

Why would a target's parent agree to Section 338(b)(10) election in a subsidiary divestiture?

- ✓ A. Because the election will reduce target's parent taxable gain if its stock basis in target's shares < target's asset basis in its assets
- B. Because the election will reduce target's parent taxable gain if its asset basis in target's assets < target's stock basis in its stock
- C. Because the deal will not complete absent agreement to such election by both buyer and seller
- D. None of the above