

11 Introduction to Mergers, Acquisitions, and Divestitures

11.1 Overview of Issues

11.1.1 Reasons for Mergers, Acquisitions, and Divestitures: Why do corporations reorganize? Some acquisitions can improve shareholder results as when a manufacturer acquires a supplier to improve the manufacturing process. Other acquisitions can be made to benefit managers (compensation strongly correlates with firm size independent of profitability) or to avoid a takeover threat. Divestitures can be triggered by a recognition that some business lines are outside the core strength of a company's management team or because better management is available.

11.1.2 Types of Mergers, Acquisitions, and Divestitures: Acquisitions can be divided in two different ways: (1) taxable vs. tax-free and (2) asset or stock acquisitions. Divestitures can be accomplished by selling a business or by placing the business into a new corporation (if it is not already in a separate corporation) and then distributing stock of the corporation to shareholders (converting a parent/subsidiary pair of corporations into brother/sister corporations, usually called a "spin-off"). Finally, a partial divestiture can be accomplished by issuing significant new equity to an investor (an "equity carve out").

11.2 Major Tax Issues Associated with Mergers, Acquisitions, and Divestitures: Whenever there is a corporate reorganization of some type, the following issues are raised: (1) will the transaction be taxable at the shareholder level; (2) will the corporation's tax attributes (NOLs, e&p account) be preserved; (3) will the transaction be taxable at the corporate level; (4) will there be a basis step-up of corporate assets; and (5) can use of debt (leverage) generate tax savings?

11.2.1 Shareholder Tax Liabilities

11.2.1.1 Mergers and Acquisitions: In a taxable stock acquisition, shareholders of the target corporation will recognize gain or loss on the difference between the value of the consideration received and their adjusted basis in their tendered stock. If the transaction qualifies as a tax-free stock acquisition, the target shareholders will be taxed on the lesser of their gain realized and the value of consideration received excluding stock of the acquiring corporation (or, in some cases, stock of the parent of the acquiring corporation).

11.2.1.2 Divestitures: If a subsidiary is sold, the selling corporation will be taxed; shareholders will be taxed only to the extent the sale proceeds are then distributed. If a divestiture occurs via a stock distribution (i.e., a spin-off), the distribution generally will be tax-free to the shareholders.

11.2.2 Effect on Tax Attributes: Most tax attributes of the target corporation survive an acquisition or divestiture. However, significant restrictions are placed on the use of target NOLs after an acquisition.

11.2.3 Target Corporate-Level Tax Effects: If an acquisition is structured as an asset acquisition, the target corporation will be taxed on the exchange unless the acquisition qualifies as a tax-free reorganization. If the acquisition is structured as a stock acquisition, the target corporation will not be a party to the transaction (and so will not incur any tax obligation) but the target shareholders will be taxed on their gain (or loss) unless the transaction qualifies as a tax-free reorganization. If the transaction is a divestiture, it generally will be a taxable asset sale by the subsidiary, a taxable stock sale by the parent corporation, or a tax-free distribution of the target stock.

11.2.4 Change in the Adjusted Basis of Target or Divested Subsidiary Assets: In a taxable asset acquisition or a taxable asset

divestiture, the purchaser will take a cost (i.e., step-up) basis in the acquired assets. Otherwise, the target assets will retain their historical adjusted basis.

11.2.5 Effect of Leverage on Mergers and Acquisitions: A corporate reorganization often provides an opportunity to substitute debt for existing equity and thereby obtain the benefit of a corporate-level interest deduction.

11.3 Nontax Issues in Mergers, Acquisitions, and Divestitures: Transaction costs in corporate reorganizations include fees to lawyers, accountants, and investment bankers as well as the costs associated with valuing the target assets and obtaining financing. Further, in a stock acquisition, the problem of hidden and contingent liabilities must be addressed.

11.4 Five Basic Methods to Acquire a Freestanding C Corporation: See **Table 11.1** (p. 11-7).

11.4.1 A's taxable purchase of T's assets: The target corporation is taxed on the gain or loss in its assets, and A takes the assets with a cost basis.

11.4.2 A's taxable purchase of T's stock, followed by an election under §338: The target shareholder's recognize gain or loss on the sales of their shares. The effect of a §338 election is to step-up the basis of the Target's assets to fair market value in exchange for an immediate recognition of the net gain or loss in the Target's assets.

11.4.3 A's taxable purchase of T's stock without a subsequent election under §338: The target shareholder's recognize gain or loss on their shares. The target's assets retain their historic basis.

11.4.4 A's acquisition of T's stock in a tax-free exchange: Generally tax-free to all parties; the consideration used in the acquisition is either voting stock of the acquiring corporation or voting stock of its parent.

- 11.4.5 A's acquisition of T's assets in a tax-free exchange: Generally tax-free to all parties; the consideration generally includes a substantial amount of stock (though the use of non-stock consideration can trigger gain to the target shareholder's). The target will liquidate as part of the transaction.
- 11.5 Four Methods to Divest a Subsidiary or Line of Business: See **Table 12.2** (p. 11-8).
- 11.5.1 Sale of stock of the subsidiary: Taxable to selling parent, and a joint election under §338(h)(10) is possible to achieve a cost basis in the subsidiary assets.
- 11.5.2 Sale of subsidiary's assets: Gain recognized by the seller, and a cost basis in the assets to the buyer.
- 11.5.3 Distribution of the subsidiary's stock, creating a brother/sister pair: Generally tax-free and no change in asset basis.
- 11.5.4 Issuance of new equity, an "equity carve-out": Generally tax-free without a change in asset basis.
- 11.6 Tax Deductibility of Goodwill and Other Intangible Assets: Under Section 197: The cost of purchased good will is amortized over 180 months. For financial purposes, the cost of goodwill is not amortized but rather is written down when and if it becomes impaired. In general, purchased goodwill will arise only in a taxable transaction.
- 11.7 Discussion Questions (p. 11-9)
- 11.7.1 Question 1: Many factors motivate acquisitions including the desire to improve efficiency, to expand management's power and to transfer wealth between stakeholders. Which of these factors is most important is not determinable.
- 11.7.2 Question 2: The key tax factors in a merger or acquisition are: 1) the tax effects on target shareholders, 2) the tax costs at the target corporation level arising from stepping-up the tax basis of the target's assets, 3) the tax benefits of stepping up the target's assets, 4) the effect of the transaction on the target's tax attributes such as NOLs, and 5) the value of any tax benefits associated with debt financing in the acquisition.

Mergers and acquisitions are not unique in their tax consequences as many transactional alternatives generate similar tax consequences (e.g., sale and leaseback, joint venture, etc.).

11.7.3 Question 3: The tax benefits are derived from the incremental depreciation deductions that will result from a higher basis in the target's assets post-acquisition. If the tax basis of the target's assets carry over, the acquirer will have a lower tax basis in the target's assets than if those assets were "stepped-up." The tax costs of generating these increased depreciation deductions are the taxes that are due at the date of the acquisition.

11.7.4 Question 4: In some cases, T may not be able to use its operating loss carryforwards. By transferring these tax attributes to the acquirer, it may more efficiently use these operating losses. There are limitations on such behavior however as discussed in Chapter 14. As an alternative to an acquisition, a target firm could purchase high explicit tax assets in order to generate taxable income which can offset historical operating loss carryforwards. An additional alternative that is in the spirit of the first would involve the NOL target firm purchasing a profitable corporation, and limitations are imposed on the subsequent use of NOLs in this context.

11.7.5 Question 5: They are: (1) a taxable purchase of the target's assets; (2) a taxable purchase of the target's stock, followed by a §338 election; (3) a taxable purchase of the target's stock without a subsequent §338 election; (4) a tax-free acquisition of the target's stock; and (5) a tax-free acquisition of the target's assets.

11.7.6 Question 6: The four basic divestiture methods are: (1) a subsidiary stock sale; (2) a subsidiary asset sale; (3) a spin-off; and (4) an equity carve-out.

- 11.7.7 Question 7: A step-up in the tax basis of the firm's assets occurs when the basis (historical value for tax purpose which is depreciated and used in gain/loss computations) is re-valued upward. This upward re-valuation increases the total amount of depreciation deductions associated with an asset. Because depreciation deductions shield income from taxation, they reduce tax liabilities and therefore increase cash retained by the firm/investor.
- 11.7.8 Question 8: Rarely because a corporate step-up in asset basis (producing a tax benefit over time) requires an immediate recognition of gain.
- 11.7.9 Question 9: A step-up structures make sense in the acquisition of a freestanding C corporation if the target C corporation has large NOLS (see chapter 16). Step-ups are common in the acquisition of subsidiaries of C corporations and in the acquisition of conduit type entities such as S corporations and partnerships.
- 11.7.10 Question 10: A firm's tax attributes include net operating loss carryforwards, capital loss carryforwards, the tax basis of assets, and the e&P account. An acquirer is concerned about these tax attributes because the acquisition's tax structure influences the size and usage of these tax attributes post-acquisition. Each tax attribute can have significant cash flow implications for the combined entity and hence, the acquirer must optimize the use of the target's tax attributes, subject to non-tax costs.
- 11.7.11 Question 11: In a carryover basis transaction, the tax basis of the target's assets is not changed as a result of the acquisition. Because a carryover basis transaction does not increase the tax basis of the target's assets, it does not generate incremental tax deductions and therefore does not generate incremental tax savings and cash flows. A step-up type acquisition (e.g., taxable asset acquisition or taxable stock

acquisition with a regular 338 election) increases the tax basis of the target's assets which results in higher periodic depreciation deductions. Therefore, a step-up structure generates incremental cash flow for the acquirer.