**Chapter 12 Suggested answers to discussion questions**

1. **When a merge is taxable?**

A deal is taxable to target shareholders if it involves purchasing the target’s stock or assets using mostly cash, debt, or nonequity consideration. Taxable deals include a cash purchase of target assets, a cash purchase of target stock, or a statutory cash merger or consolidation, which commonly includes direct cash mergers and triangular forward and reverse cash mergers

1. **Why paying cash for target assets is taxable?**

If a transaction involves a cash purchase of target assets, with the buyer assuming none, some, or all of the target’s liabilities, the target’s tax cost or basis in the acquired assets is increased, or “stepped up,” to its fair market value (FMV), equal to the purchase price (less any assumed liabilities) paid by the acquirer. The additional depreciation in future years reduces the present value of the tax liability of the combined firms. The target firm realizes an immediate gain or loss on assets sold equal to the difference between the FMV of the asset and the asset’s net book value (i.e., book value less accumulated depreciation). The target’s shareholders could be taxed twice—once when the firm pays taxes on any gains and again when the proceeds from the sale are paid to the shareholders as either a dividend or a distribution following liquidation of the corporation. A liquidation of the target firm may occur if a buyer acquires enough of the assets of the target to cause it to cease operations.3 To compensate the target company shareholders for any tax liability they may incur, the buyer usually will have to increase the purchase price.

1. **Why paying cash for target stocks is taxable?**

Taxable transactions (i.e., those including something other than acquirer stock) involve the purchase of the target’s voting stock to avoid double taxation of gains to the target’s shareholders. An asset purchase automatically triggers a tax on any gain on the sale by the target firm and another tax on any payment of the after-tax proceeds to shareholders. Taxable stock purchases avoid double taxation because the transaction takes place between the acquirer and the target firm’s shareholders. However, target shareholders may realize a gain or loss on the sale of their stock. Assets may not be stepped up to their FMV in these types of transactions. Since from the IRS’s viewpoint, the target firm continues to exist, the target’s tax attributes [e.g., investment tax credits and net operating losses (NOLs)] may be used by the acquirer following the transaction, but their use may be limited by Sections 382 and 383 of the Internal Revenue Code.

1. **When does the transaction become tax free?**

A deal is tax free if the form of payment is mostly acquirer stock. Deals may be partially taxable if the target shareholders receive something other than the acquirer’s stock. This nonequity consideration, or boot, generally is taxable as ordinary income. If the transaction is tax free, there is no step-up of net acquired assets to their FMV.

To qualify as tax free, a deal must provide for continuity of ownership interests, continuity of business enterprise, and a valid business purpose and satisfy the step-transaction doctrine. To demonstrate continuity of ownership interests, target shareholders must own a substantial part of the value of the combined firms. This requires the purchase price to consist mostly of acquirer stock. Continuity of business enterprise requires the acquirer to use a significant portion of the target’s “historic business assets” in a business6 to demonstrate a long-term commitment on the part of the acquirer to the target. This usually means an acquirer must buy

“substantially all” of the target’s assets. Furthermore, the transaction must have a valid business purpose, such as maximizing the profits of the acquiring corporation, rather than only for tax avoidance. Finally, under the step-transaction doctrine, the deal cannot be part of a larger plan that would have constituted a taxable deal.7 Tax-free deals are also called tax-free reorganizations. The continuity of interests, business enterprise, and step-doctrine requirements are intended to prevent transactions that more closely resemble a sale from qualifying as a tax-free reorganization.

1. **Examples of tax savings in a merger transaction.**

Tax attributes, such as NOL carryforwards and carrybacks, capital loss carryovers, excess credit carryovers, tax basis in company assets, and tax basis in subsidiary companies, can represent considerable value to acquiring firms in terms of tax savings. The IRS allows acquirers to realize tax savings from additional depreciation resulting from the revaluation of net acquired target assets to their fair FMV13 or from the target’s other tax attributes, but not both. Thus, acquirers can use a target’s tax attributes in taxfree reorganizations and in taxable purchases of stock without a Section 338 election, since net acquired assets are not revalued to their FMV. Acquirers cannot use the target’s tax attributes in taxable purchases of assets and taxable purchases of stock undertaken as a 338 election, since net acquired assets are revalued to their FMV.14

1. **What is tax inversion?**

Known as tax inversions, reincorporations in low-tax areas such as Bermuda, the Cayman Islands, or Ireland are not new. However, the process has become increasingly cumbersome due to new regulations preventing firms from simply opening a new office abroad or moving to a country where they have little business. Today, most inversions are a result of cross-border M&As. Under legislation passed more than a decade ago, American company shareholders (i.e., premerger acquirer shareholders) must own less than 80% of the new combined firms. Consequently, the only effective way for an American firm to “invert” in a manner consistent with the law is by reincorporating abroad as part of a merger or acquisition with relatively large firms. This limits the number of the potential target firms large enough to satisfy this requirement.

1. **What is good will?**

the purchase price or acquisition cost is determined and then, using a cost-allocation approach, assigned first to tangible and then to intangible net assets and recorded on the books of the acquiring company. Net assets (or net acquired assets) refer to acquired assets less assumed liabilities. Any excess of the purchase price over the fair value of the acquired net assets is recorded as goodwill. Goodwill is an asset representing future economic benefits arising from acquired assets that were not identified individually. Current accounting standards stipulated in SFAS 141R require an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the target to be measured at their fair value as of the acquisition date. The acquisition date generally corresponds to the closing date rather than to the announcement or signing date.

1. **How to calculate good will?**

For financial-reporting purposes, the purchase price paid, including the fair value of any noncontrolling interest (FMVNCI) in the target at the acquisition date, for the target company consists of the FMV of total identifiable acquired tangible and intangible assets (FMVTA) less total assumed liabilities (FMVTL) plus goodwill (FMVGW). The difference between FMVTA and FMVTL is called net asset value. PP is the total consideration transferred to target firm shareholders for net acquired assets less any interest not owned by the acquirer (i.e., noncontrolling interest). Eq. (12.1) and Eq. (12.2) are equations.

Goodwill is the difference between the purchase price and the FMV of the target’s net asset value. Positive goodwill is recorded as an asset, whereas 699

negative goodwill (i.e., a bargain purchase) is shown as a gain on the acquirer’s consolidated income statement.