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STUDENT : Christopher C. Alord

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GLOBAL TAX PLANNING ISSUES
AND THEIR IMPACT ON
MANAGERIAL DECISION MAKING

by

Christopher C. Alford and Kory L. Schestag

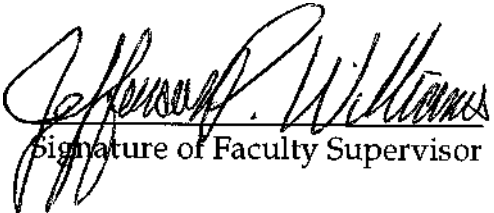
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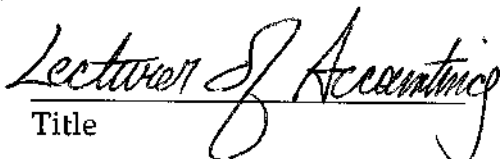
Faculty Comments

Tax planning has often been approached from a unilateral perspective, focusing only on the tax effect of a proposed transaction on only one of the parties to the transaction. A richer tax planning perspective, however, can be developed by considering the tax implications to each of the various parties to a transaction.

The authors of this paper use the global tax planning framework developed by Scholes and Wolfson to present a series of examples highlighting the role of effective tax planning in various areas of business management. Their examples demonstrate the intricacies of a dynamic tax environment and the different and often competing interests of the taxing authorities and the contracting parties to common business situations.

This paper indicates that its authors have gained the knowledge of tax law and have developed the effective tax planning skills identified at the outset as the goals of their independent research project.


Signature of Faculty Supervisor


Title

This paper explores a variety of global tax planning issues relevant to managerial decision making. The nature of tax law is variability over time, and as such we will attempt to provide a structure of tax planning which will be applicable under a wide range of circumstances. For example, many of the rates used in our examples are arbitrary, and not necessarily reflective of current tax law. Following a discussion of each of these issues will be a real life tax planning example that considers some of the topics discussed throughout the paper.

The issues to be explored are as follows:

1. Organizational Form
2. Implicit Taxes
3. Compensation Planning
4. Retirement Planning
5. Multijurisdictional Tax Issues
6. Property Transactions - Installment Sales
7. Mergers and Acquisitions

ORGANIZATIONAL FORM

Let's consider a wealthy individual that faces a personal income tax rate of 70%, a capital gains exclusion rate of 50%, and can earn a before-tax rate of return on investments of 15%. Also, the corporate income tax rate is 48%.

The required before-tax return on corporate forms relative to partnership

forms is:

where $R_c / R_p = (1 - T_p) / [(1 - T_c) * (1 - T_s)]$
 R_c = before tax return on corporations
 R_p = before tax return on partnerships
 T_p = personal tax rate
 T_c = corporate tax rate
 T_s = effective shareholder rate (i.e. capital gains rate)

Substituting the facts in the issue,

$$R_c / R_p = (1 - .7) / [(1 - .48) * (1 - .35)] = .8876$$

That is, corporate returns must be at least 88.76% of partnership returns for the corporate form to be preferred. The corporation needs only a 13.31% before-tax return, and in this case the returns are the same regardless of form, 15%. Therefore, the corporate form is preferable to the partnership form under these circumstances.

Now, extending the life of the corporation to 5, 10, and 15 years will increase after-tax savings:

5 years	partnership	$1 + (.15 * (1 - .7))^5 =$	1.2462
	corporation	$1 + (.15 * (1 - .48) * (1 - .35))^5 =$	1.2805
10 years	partnership	$1 + (.15 * (1 - .7))^{10} =$	1.5530
	corporation	$1 + (.15 * (1 - .48) * (1 - .35))^{10} =$	1.6900
15 years	partnership	$1 + (.15 * (1 - .7))^{15} =$	1.9353
	corporation	$1 + (.15 * (1 - .48) * (1 - .35))^{15} =$	2.0998

This shows, in the 10 year life span example, that the partnership will yield a return of 55.3%, while the corporate form will yield a 69% overall return. The longer the life, the better the corporate form performs.

This situation changes, however, if the personal tax rate falls to 50%. Substituting into the equation above once again, $R_c / R_p = (1-.5) / [(1-.48)*(1-.25)] = 1.2821$, meaning that the corporate before-tax return must be 28.21% higher than the partnership's, or 19.23%. Since they are equal once again, the partnership will outperform the corporation after-tax, all other things equal.

Other nontax considerations include the advantages of corporate form and switching costs. An advantage of corporate form is limited liability, which may be a desirable aspect lacking in a partnership. If the after-tax benefits outweigh these other considerations, organizational forms should be switched.

The levels of the different tax rates can favor a particular organizational form, and that form can change over time as the tax rates change. While not explored here, the possibilities include one organization being favored in the short-term, while another is favored long-term, for a single given set of rates.

IMPLICIT TAXES

Consider three different assets available for investment, identical in all respects except for rate of return and tax exemption status. The first yields a fully taxable 7% return, the second a half-tax exempt 6% return, and the last a fully exempt 5% return.

The optimum ranges for the investments are as follows:

For personal tax rates from 0-25%, the fully taxable 7% asset provides the best after-tax return,

For tax rates of 25-33%, the half-exempt 6% asset provides the best after-tax return,
For tax rates of 33-100%, the fully exempt 5% asset provides the best after-tax return.

The wealthy taxpayer from the Organizational Form section above was in the 50% marginal tax bracket. Therefore, the tax-exempt investment would be the best choice for her. Her returns on the other two would be a net 3.5% and 4.5% after-tax, respectively. The trend shows that the wealthier the taxpayer, the more desirable the tax-exempt investments, in a progressive tax structure.

Given \$150,000 to invest, and that the progressive scheme above were in place, the 6% half-exempt investment would be the best option. It would yield an after-tax net income of \$8,100, vs. \$7,800 and \$7,500 for the fully taxable and fully exempt investments, respectively.

More interestingly, if a portfolio of the three investments could be constructed, the first \$5,000 of taxable income would be taxed at 20%, and so should come from the 7% investment (from the optimum ranges above.) The next \$5,000 of taxable income should come from the 6% investment, and the remainder which is taxed at 40% should come from the tax-exempt investment. This results in up to \$71,429 (5,000 / 7%) preferably being invested at the fully taxable 7%, an additional \$166,667 (10,000 / 6%) being invested in the 6% investment, and any additional investment dollars beyond \$238,095 (71,429+166,667) being invested at 5% to earn income free of taxation. Our

wealthy taxpayer, wishing to invest \$500,000, would choose \$71,429 at 7%, \$166,667 at 6%, and \$261,905 at 5%.

An investor's marginal tax rate heavily influences the type of investment the investor should make. If the explicit tax savings outweigh the implicit tax from the lower rate of return, the investor should choose tax-exempt investments. If, however, the implicit taxes are too great to offset the explicit tax savings, the investor should choose the best return available.

COMPENSATION PLANNING

Consider an individual and corporation (the individual's employer) who are considering a deferred compensation plan. Their decision is based on the tax rate and rate of return information provided in the table below:

Amount of compensation deferral	Tco	Tc5	Tpo	Tp5	Rc5	Rp5
\$0	35%	40%	40%	35%	8%	6%
\$20,000	35%	40%	35%	35%	8%	7%
\$40,000	35%	40%	30%	35%	8%	7%
\$60,000	35%	40%	30%	40%	8%	7%
\$80,000	35%	40%	25%	40%	8%	8%
\$100,000	35%	40%	25%	45%	8%	9%

- Tco = employer's current marginal tax rate
- Tc5 = employer's marginal tax rate in five years
- Tpo = employee's current marginal tax rate given the compensation deferral amount shown in the first column
- Tp5 = employee's marginal tax rate in five years after receiving the deferred compensation payment corresponding to the salary deferral shown in the first column
- Rc5 = employer's annualized after-tax rate of return on marginal five year investments
- Rp5 = employee's annualized after-tax rate of return on marginal five year investments

If we ignore nontax considerations, the optimal level of compensation that is to be deferred is between \$60,000 and \$80,000, due to the fact that the corporation can earn a better return on the money than the employee can up to \$80,000 of deferral.

Now let's determine if the employee is better off or worse off on the first dollar of salary that is deferred if the employer paid the deferred compensation amount that makes it indifferent between salary and deferred compensation. For each \$1 of salary deferred today, the employer could afford to pay \$1.0833 ($\$1(1-35/1-.40)$) in five years (plus after-tax earnings on investment for the five years). To the employee, \$1 today is worth \$.60 after tax. The \$1.0833 in deferred compensation, plus interest for five years, has a present value of $1.0833(1-35)$ or \$.70 after tax. Therefore, the employee would be better off on the first dollar deferred.

Now let's determine if the employee is better off or worse off on the 100,000th dollar of salary that is deferred. Again, for each \$1 of salary deferred today, the employer could afford to pay \$1.0833 ($\$1(1-35/1-.40)$) in five years (plus after-tax earnings on investment for the five years). To the employee, \$1 (the 100,000th dollar) today is worth \$.75 after tax. The \$1.0833 in deferred compensation, plus interest for five years, has a present value of $1.0833(1-.45)$ or \$.60 after tax. Therefore, the employee would be worse off on the 100,000th dollar deferred.

If the deferred compensation contract is structured so that it is payable only if the employee remains within the employ of the firm and this condition, in turn, reduces the likelihood of employee turnover and also increases employee performance (since the employee wishes to avoid being fired), there is a large difference in the desirability of this deferred compensation arrangement between the employer and the employees. This condition increases the desirability of the arrangement for the employer because the low turnover reduces the amount of hiring and training costs as well as creates a more experienced work force overall. The increase in performance, in addition to the lower costs discussed above, will allow the company to be more efficient and therefore more profitable. However, this condition decreases the desirability of the arrangement from the employee's point of view. This is the case because it reduces the employee's flexibility in the work force. If she wants to receive full compensation from the company, she must stay at that job for the required period of time, which doesn't allow her to pursue a more advantageous job for her without bearing some large costs (forgone compensation).

Now let's assume that we have implemented the arrangement discussed in the paragraph above and the employee reports that her tax rate will drop dramatically to 20% in year two and then be 45% in years three, four and five. If this is the case there are a number of things to consider when determining whether the arrangement should be restructured so that the employee may take

advantage of her low tax rate. We need to consider the costs to the employer should this plan be restructured. If the employer's tax rate has changed, it will greatly impact the decision. Also, the administrative costs that would be incurred or saved by the restructuring should be considered. Other employee and employer incentives must also be considered to make the right decision. Once these considerations have been quantified, the gains for the employee should be netted against the costs to the employer. If it comes out that it is a net gain, then the company should go ahead and restructure, but maybe give her a little less than what the original amount would have been had she received it in five years. However, if it comes out as a net loss, the restructuring should not take place.

RETIREMENT PLANNING

Currently, retirement savings plans allow current deductions with limitations, tax-free growth until retirement, and then tax the distributions from such plans during retirement. Rates could differ, of course, over time.

An alternative plan would contain nondeductible contributions with tax-free growth and distribution of plan assets. This plan would appeal to those taxpayers who expect to be in higher tax brackets than they currently are when the distributions will be taken. Since all future taxes associated with the plan could be avoided for a relatively low cost currently, the plan would appeal to

most pensioners. As long as the future tax savings outweigh the initial tax loss and expected growth, a taxpayer would prefer the plan.

Such a plan would increase tax revenues for the government in the short run, but likely reduce revenues in the long run as no distributions would be taxable. Other effects, however, may include a reduction in the dependence of the current generation on entitlement programs such as social security, implying a decrease in required government spending to accompany the loss of revenue.

Taxpayers in general would likely take full advantage of this desirable plan, with a large resulting increase in the aggregate level of savings through such a pension structure.

A second alternative would contain deductions for contributions with distributions taxed at the same rate as the original deductible contributions. This plan is, in actuality, fundamentally identical to the first alternative. The only major change is the timing of the government's tax revenues. For example, consider \$1,000 invested at 10% for 20 years under plan 1 and plan 2 where the current rate is 40%:

$$1: \quad 1000 * (1-0.4) * (1.1)^{20} = \$4,036.5$$

$$2: \quad 1000 * (1.1)^{20} * (1-0.4) = \$4,036.5$$

Clearly, the factors involved have just switched places.

Alternative 2 is a desirable option for those taxpayers who will experience lower tax rates in retirement than the marginal brackets they are currently in.

This is in contrast to the current plan and the first alternative. Consider the same facts as above, except for the tax rate during retirement:

$$\begin{aligned} \text{If 30\%:} & \quad [1000 * (1.1)^{20} * (1-.3)] + [1000 * (.3-.4)] = \$4,609.25 \\ \text{If 50\%:} & \quad [1000 * (1.1)^{20} * (1-.5)] + [1000 * (.5-.4)] = \$3,463.75 \end{aligned}$$

This plan is clearly superior to the current plan and the first alternative's \$4,036.5 when rates fall, but undesirable otherwise.

MULTIJURISDICTIONAL TAX ISSUES

Consider a U.S. multinational firm that has \$150 million of earnings and profits in a foreign subsidiary that has already been taxed at a rate of 25% in that country. The firm must make a decision on whether to reinvest the earnings in the foreign subsidiary or repatriate them back to the U.S. where taxable income would be triggered at a 40% tax rate. In addition, the foreign country does not impose a withholding tax on the repatriation.

If the money was repatriated today, the dividend would trigger \$200 million ($150/(1-25\%)$) in taxable income in the U.S. In the U.S., dividends received from a foreign subsidiary must be grossed up by the amount of any direct taxes (e.g. withholding taxes) paid and any indirect taxes (taxes paid on the income in the foreign country) deemed paid in the foreign country. Because there were no withholding taxes, this income is only grossed up by the indirect taxes. The \$200 million in taxable income would generate a tax liability in the

U.S. of \$80 million ($200 * 40\%$). However, the U.S. allows a foreign tax credit of the sum of the direct and indirect taxes. In this case our company gets a \$50 million credit ($200-150$) and therefore must pay additional tax to the U.S. in the amount of \$30 million. If, for example, the foreign country had imposed a 10% withholding tax on the repatriation, the dividend would have been \$135 million ($150-(10\% * 150)$) to the firm. For U.S. taxable income purposes, the \$135 million must be grossed up by the direct taxes paid (\$15 million withholding tax) and the indirect taxes paid (\$50 million), and we again reach \$200 million of U.S. taxable income. This again generates a tax liability of \$80 million but the firm now has foreign tax credits of \$65 million ($50 + 15$) and must pay additional tax to the U.S. in the amount of \$15 million.

Suppose the \$150 million could either be reinvested in the foreign subsidiary and generate returns of 13% before tax and 9.75% after tax or it could be repatriated and invested to earn 15% before tax and 9% after tax in the U.S. The decision will rest on the investment horizon. Following are the calculations to help make the decision based on investment horizons of 1,5,10, and 20 years. Our investment in the U.S. would yield the following:

1 year	$120(1.09)$	=	130.80
5 years	$120(1.09)^5$	=	184.63
10 years	$120(1.09)^{10}$	=	284.08
20 years	$120(1.09)^{20}$	=	672.53

Reinvestment in the foreign subsidiary would yield the following upon repatriation at the end of the investment horizon:

			U.S. Taxable		Foreign	Additional	Investment	
			Dividend	Income	U.S. Tax	Tax Credit	Tax Due	Proceeds
1 year	$150(1.0975)$	=	164.63	219.50	87.80	54.88	32.93	131.70
5 years	$150(1.0975)^5$	=	238.84	318.46	127.38	79.61	47.77	191.08
10 years	$150(1.0975)^{10}$	=	380.31	507.08	202.83	126.77	76.06	304.25
20 years	$150(1.0975)^{20}$	=	964.23	1,285.64	514.26	321.41	192.85	771.39

Under these conditions, investing abroad dominates for every investment horizon.

Now, if the foreign country imposes a withholding tax of 10% on the repatriation, the U.S. investment proceeds would stay the same, and the reinvestment in the foreign subsidiary would be as follows:

			Withholding	U.S. Taxable		Foreign	Additional	Investment
			Dividend	Tax	Income	U.S. Tax	Tax Credit	Tax Due
1 year	$150(1.0975)$	=	164.63	16.46	219.50	87.80	71.34	16.46
5 years	$150(1.0975)^5$	=	238.84	23.88	318.46	127.38	103.50	23.88
10 years	$150(1.0975)^{10}$	=	380.31	38.03	507.08	202.83	164.80	38.03
20 years	$150(1.0975)^{20}$	=	964.23	96.42	1,285.64	514.26	417.83	96.42

Under these circumstances, because the U.S. tax rate is higher than the foreign taxes combined, the reinvestment generates the same exact proceeds, but some of the taxes paid have been shifted from the U.S. government to the foreign government due to the extra withholding tax.

Now consider a tax rate of 45% in the U.S. The investment in the U.S. now gives proceeds of the following:

1 year	$120(1.0825)$	=	129.90
5 years	$120(1.0825)^5$	=	178.37
10 years	$120(1.0825)^{10}$	=	265.13
20 years	$120(1.0825)^{20}$	=	585.79

The reinvestment abroad is changed to:

			U.S. Taxable		Foreign	Additional	Investment	
		Dividend	Income	U.S. Tax	Tax Credit	Tax Due	Proceeds	
1 year	$150(1.0975)$	=	164.63	219.50	98.78	54.88	43.90	120.73
5 years	$150(1.0975)^5$	=	238.84	318.46	143.31	79.61	63.69	175.15
10 years	$150(1.0975)^{10}$	=	380.31	507.08	228.19	126.77	101.42	278.89
20 years	$150(1.0975)^{20}$	=	964.23	1,285.64	578.54	321.41	257.13	707.10

Now that the tax rate is higher in the U.S., if the investment horizon is 1 or 5 years, the firm should repatriate the money now and invest in the U.S.

However, if the investment horizon is 10 or 20 years, then the money should be reinvested in the foreign subsidiary.

Let's now return to the 40% tax rate in the U.S. and then suppose that the foreign country tax rate is 35%. The U.S. investment is the same as the first two cases of this section, but the reinvestment abroad changes to the following:

			U.S. Taxable		Foreign	Additional	Investment	
		Dividend	Income	U.S. Tax	Tax Credit	Tax Due	Proceeds	
1 year	$150(1.0845)$	=	162.68	250.27	100.11	87.59	12.51	150.16
5 years	$150(1.0845)^5$	=	225.03	346.20	138.48	121.17	17.31	207.72
10 years	$150(1.0845)^{10}$	=	337.59	519.37	207.75	181.78	25.97	311.62
20 years	$150(1.0845)^{20}$	=	759.77	1,168.88	467.55	409.11	58.44	701.33

Again under these conditions, the reinvestment abroad dominates because of the larger foreign tax credits that were generated from the higher tax rate in the foreign country.

Now consider a U.S. corporate taxpayer that wishes to receive a dividend from a subsidiary in country A, which has a tax rate of 25%, and a withholding rate on dividends of 20%. The U.S. corporate rate is 35%.

Each dollar of dividend received by the firm in the U.S. will result in \$1.67 dollars of taxable income in the U.S. (The markup includes both foreign income and withholding taxes, $(\$1 / .8) / .75 = \1.67 .) The firm will, however, be eligible for a foreign tax credit of the minimum of [US taxes due, foreign taxes paid.] The lower amount in this case is the U.S. tax due, $\$1.67 * .35 = .585$, with the difference of 8.5 cents ($.67 - .585 = .085$) eligible for carryback / forward treatment. Overall U.S. tax liability, therefore, will not increase due to the dividend.

Classifying the income as an interest payment rather than a dividend would achieve two things: it would reduce taxable income in country A to \$0, and it would entirely avoid withholding taxes. Each dollar of income would be included in U.S. taxable income, and result in \$.65 of after-tax profit. That same dollar would result in only \$.60 of after-tax profit if received as a dividend from country A, $\$1.00 * .75 * .8 = \0.60 . No U.S. tax liability would be incurred, but the foreign taxes would exceed the FTC's reach.

If a 30% withholding tax is placed on interest payments, there is still an after-tax profit of \$.65, but the taxes flow to the separate countries differently. Now \$.30 will be paid to country A, while the U.S. tax liability of \$.35 is offset by

a \$.30 FTC, with a remaining liability of \$.05. Note that, under these circumstances, as long as the withholding tax on interest is less than the U.S. tax rate, interest will always be preferable to equity.

If we allow a longer investment and repatriation horizon, equity becomes more and more preferable. Because of the lower tax rate in country A, more earnings will be reinvested, and over time the foreign subsidiary will outgrow a similar U.S. firm. At the end, when the earnings are finally repatriated, there will be a withholding tax, but given enough time, the extra accumulated and compounded earnings could outweigh even the extra withholding tax.

In a country where the tax rate is lower than the U.S., it would be preferable to leave the earnings in that country as long as possible, or, if repatriation is necessary, to utilize interest financing rather than equity. In a country with a higher tax rate than the US, the best method of repatriation is likely to be interest.

PROPERTY TRANSACTIONS - INSTALLMENT SALES

When dealing with property transactions, an installment sale can be very beneficial for the seller. An installment sale allows deferral of the recognition of gain on the sale until principal is received. Let's look at an example to help demonstrate this claim.

Consider an owner of piece of commercial real estate with a fair market value of \$5 million. The owner has a tax basis of \$500,000 in the property and faces a tax rate of 30%. If the owner sells the property for \$5 million in cash, he will recognize a \$4,500,000 gain ($5,000,000 - 500,000$), which will generate a \$1,350,000 ($4,500,000 * 30\%$) tax liability. Therefore he holds \$3,650,000 in cash after the sale.

However, if the owner sells the property for a \$5 million, 20 year, 10% note where the principal is paid in a balloon payment at the end of the 20 years, he can use the installment method for tax gain recognition. He will only have to pay tax on the annual interest payments and then on the gain from the sale in 20 years, when the principal is repaid. Assuming the same tax rate of 30% and discount rate of 7% (the rate at which the seller can invest the proceeds from a cash sale today in tax-exempt bonds), the present value of the income stream from the installment note is \$4,651,134. This amount is made up of the present value of the proceeds in 20 years (\$3,650,000 after-tax) and the present value of the after-tax interest payment stream of \$350,000 per year ($\$5,000,000 * 10\% * (1 - 30\%)$). Therefore, the owner is \$1,001,134 better off by entering into the installment transaction.

Assuming the same facts in the above example except for the fact that the owner can reinvest at 8% in tax-exempt bonds, let's determine if the owner is still better off with an installment sale. Under this scenario, discounting the

installment payments at 8% for 20 years will result in a present value of \$4,219,512, which is closer to the cash sale value, but still makes the owner better off with an installment sale.

Now, assume that the owner makes the installment sale. Then, ten years later he finds out that his tax rate will increase to 40% for subsequent years. He must now decide whether to sell his note now and recognize the gain at a 30% tax rate and then invest the net proceeds in tax-exempt bonds at 6%, or he can hold on to the note and pay at a 40% tax rate on the future interest and principal payments. The value of the sale of note on that date is still \$3,650,000. The present value of the installment note for the next ten years is the sum of the present value (discounted at 6% for 10 years) of the after-tax interest payment stream of \$300,000 per year ($\$5,000,000 \times 10\% \times (1 - 40\%)$) and the present value (discounted at 6% for 10 years) of the after-tax proceeds of the principal payment of \$3,200,000 ($\$5,000,000 - (4,500,000 \times (1 - 40\%))$). This value is \$3,994,889, which once again makes the owner better off if he continues to hold the installment note, even at higher tax rates. For these two options to be equal, the owner would have to sell the note for \$5,706,984 ($\$3,994,889 / (1 - 30\%)$) when he discovers the future change in tax rates.

If we change the facts of the immediately preceding example so that the owner can invest at 7%, rather than 6%, after the sale of the note, will the installment note still be better? After discounting at 7%, the present value of the

income stream from the installment note for the second ten years is \$3,733,792 which is much, much closer to the value of the sale of the note, but still makes the owner \$83,792 better off if he holds the note to maturity.

As can be seen through illustrations above, the tax deferral impact of the installment sale outweighs a current recognition and investment in a great number of circumstances. While this won't always be the case, it is a very strong ally of sellers of property and should be considered on almost every occasion.

MERGERS AND ACQUISITIONS

Mergers and acquisitions are not primarily motivated by tax considerations, but the tax effects must be addressed. When an acquiring company purchases another firm, there are two major categories of tax considerations to keep in mind. The first is the whether the transaction is a taxable event or a tax-free event. The second is the final structure of the acquiring organization, including both the parent and the company acquired.

The purchaser would almost always prefer a taxable exchange, all other things being equal. The assets of the company purchased will then be written up to fair market values, and any tax attributes possessed by the firm acquired will be retained. On the other hand, the seller of the firm would prefer a non-taxable exchange, in order to avoid paying either a corporate-level capital gains tax or a shareholder-level capital gains tax.

In reality, when there is actually a choice between a taxable and non-taxable treatment, the following occurs. The parties use their relative best tax positions as leverage in a negotiations of sorts. That treatment is used which results in the lowest tax considering both participants overall, even if it results in full tax for one and nearly no tax for the other. The participant which was forced to bear the full weight of the tax is then compensated by the party with the proportionally high tax savings, according to the negotiations. Both parties are thus made better off at the expense of the U.S. Treasury.

After the acquisition has occurred, the new parent must then choose a structure which optimizes both corporate objectives and potential tax considerations. Perhaps the acquired corporation should remain a corporation, or change organizational form into a partnership. Perhaps it should be merged into the parent corporation instead of being a stand-alone entity. The acquiree may be placed several tiers below the parent to isolate any potential legal considerations. Whatever is decided upon should ultimately, of course, consider taxation implications.

REAL LIFE EXAMPLE - FORD MOTOR COMPANY'S ACQUISITION OF ASSOCIATES FIRST CAPITAL

In October, 1989, Ford Motor Company acquired the Associates Corporation, the nation's third largest independent finance company, for \$3.35

billion from Paramount Communications Corporation. The Associates, based in Dallas, possessed assets of nearly \$14 billion at the time of the acquisition. The transaction was Ford's largest financial acquisition to date. Paramount recognized an after-tax gain of \$1.2 billion on the sale in the fourth quarter.

The purchase was structured in the following manner: a separate holding company was formed in which Ford possessed a 75% interest, while the holding company owned 100% of the Associates. Minority interests, primarily composed of institutional investors in a so-called 'private placement market', paid \$800 million for a 25% interest in the holding company. The 25% interest is composed of voting preferred stock. In addition to the Associates, the holding company owned Ford's American Road Insurance Co., U.S. Leasing, Ford Motor Land Development, and Ford Leasing Development Co. The structure is perfect for Ford, as it maintains virtually total control over the Associates, and since preferred stock was used instead of common, Ford will also retain all of the upside potential as the preferred stock will function much the same as debt in this situation.

The acquisition of the Associates had major tax implications for Ford, as any transaction of this magnitude would certainly possess. In structuring the acquisition in the manner that ultimately occurred, Ford was able to save potentially millions through tax savings. The transaction was not entered into for strictly tax reduction motivations; that is, Ford had a legitimate business

purpose in acquiring the Associates. Ford did, however, take great care to plan for tax considerations. The exact tax savings are unknown, but one analyst estimated the tax savings to range in the “many millions of dollars.” In fact, another analyst, Charles Bee, has suggested that Congress may “look again in this area, because there are probably so many dollars involved.” A Vice President at Ford commented one year later that Ford’s acquisition of the Associates was a “clear winner.”

Ford’s construction of this acquisition was, for the most part, an effort to maximize its available foreign tax credits. A section of the Tax Reform Act of 1986 that reformed foreign tax credit usage requires that a corporation take its worldwide interest expense and prorate it according to where its assets are held. For example, if half of a company’s assets (by value) are located within the United States and the other half abroad, then half of its worldwide interest expense would be apportioned to its domestic operations and the other half to its foreign operations. The assets considered for this calculation are those that are held by the consolidated group. A subsidiary is considered part of the consolidated group if 80% of it is controlled by other members of the consolidated group.

Associates incurs millions of dollars of interest expense each year so that it may provide the capital necessary for its financing operations. Ford has a substantial amount of its assets located overseas. If Ford were to make

Associates part of its consolidated group, through an 80% ownership of the holding company, it would have to apportion much of Associates' interest expense to its foreign operations which would therefore dramatically reduce its foreign source taxable income on its U.S. corporate income tax return. This reduction in foreign source taxable income would reduce the amount of foreign tax credits available to be used against Ford's U.S. tax liability, thereby generating a higher U.S. and overall tax liability. However, because of Ford's construction of this acquisition, it did not reach the 80% ownership plateau; therefore, Associates will file its own corporate income tax return. Because it is not part of the consolidated group, Associates will not have to apportion its interest expense based on Ford's assets.

Ford did not acquire Associates for its tax attributes or any other tax considerations. The Associates did not possess any NOL carryovers or capital loss carryovers that Ford could utilize. There were clear business considerations for acquiring the Associates, but the acquisition created potential tax problems from Associates' massive amount of interest expense. The solution Ford crafted to alleviate these problems was ingenious. They maneuvered through a rule designed to eliminate abuses in another area and used it to their advantage, saving themselves millions of dollars. Ford earns high marks for its structure of its acquisition of Associates.

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