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Independent Study Project Report

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PROFESSOR **:**

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TITLE **: Tax issues with regards to mergers and acquisition**

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<u>Research on Tax Issues with regards to Mergers and Acquisition</u>

1998 has been called the year of Mergers and Acquisition (M&A). The merger or acquisition of a company refers to the complete absorption of one company by another, wherein the acquiring firm retains its identity and the acquired firm ceases to exist as a separate entity. In the U.S, a series of mega-deals, primarily in the financial services and telecommunication industries, have given new meaning to the concept of mergers and acquisition.

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While most Mergers and Acquisitions' primary objective has to do with a businesses' strategic planning, the importance of tax implications cannot be ignored. One of the most important issue to focus in considering the wisdom of a merger or acquisition are the tax issues involved in restructuring a business. These issues can be classified as into either taxable or tax free transactions.

Determining whether a M&A is a taxable or a tax-free transaction, depends on how the buyer pays the purchase price, also called the considerations, in merging with or acquiring target company. In compliance with the Internal Revenue Services' rule, the target company will be taxed if it receives a recognized gain from the deal.

Taxable Transaction

Taxable Treatment for Mergers and Acquisition simply means that the seller of the company will be paying a tax on the profits from the sale. Within the taxable treatment, the transaction can be either a taxable stock purchase or a taxable asset purchase.

M&A Allium

The taxable stock transaction is a transaction in which the buyer is simply buying the other company's stock. The target shareholder will be taxed at a capital gains rate on the sale of shares. Usually, the buyer will pay a basis cost, or the transaction cost above the fair market value for the target company's stocks. These costs for acquiring the stocks of the target company cannot receive a tax adjustment to be deducted in the future until the stocks are sold.

The other taxable transaction, the asset transaction, is a transaction in which the buyer purchases various assets of the other company. Unlike the taxable stock transaction, the costs of obtaining the target assets is tax deductible only when the assets are sold. By deferring the stock sales, the buyer can thus than pay less tax on current tax returns. The target company, on the other hand, would also need to pay a capital gains tax on the sale of the assets. This is a main disadvantage of this asset because of the double taxation. Because of the required to pay, most companies do not favor this kind of transaction.

Tax Free Transaction

Tax Free Transaction simply means that both the buyer and the acquired company do not have to pay a tax on the reorganization. Under the Internal Revenue's Code Section 368, in order to have a tax-free reorganization, the deal must meet the following three judicial requirements:

1) For Business Purposes: Reorganization must be purely of business purposes.

2) Continuity of shareholder's interest: The target Company's shareholders must continue their ownership interest by having an ownership interest in the acquired company.

3) Continuity of Business Enterprise: The acquired company needs to maintain a certain percentage of its original business.

Once the requirements are met, the M& A transactions has the following seven options to choose from according to the both company's business interest, each option, in turn, has a specific sets of requirements. This is to be found under the subparagraphs of Internal Revenue Code Section 368(a)(1):

A) Statutory Merger or Consolidation

Statutory Merger or Consolidation is a popular structuring plan in which the buyer acquires the target company's assets, thus the target company ceases to exist as a single and separate entity. The transaction needs to meet three mandatory requirements: shareholders of the buyer and the acquired company need to approve the transaction, cash must be distributed to shareholders that reject the deal, and the buyer must assume all of the target's liabilities. The advantage of this transaction lies in its flexibility in consideration. The disadvantage is that the target company, because it loses its identity, must have the buyer resume all liability. This structuring plan is also similar to the stock for asset transaction, which will be introduced later.

B) Stock for Stock

The acquisition by one corporation exchange for all or part of its voting stocks with another corporation is called a stock for stock tax-free transaction. There are two requirements for this transaction. First, the consideration, or the purchase price, needs to be entirely in the form of Buyer's voting stock. Second, the buyer need to own at least 80% of the acquired company's stock after the transaction is settled. One main advantage of this transaction is that the target can retain it's corporate identity. However, the buyer is liable for all of the target company's liabilities.

C) Stock for Assets

The acquisition by one corporation by an exchange of all or part of its own voting stocks for the properties of another corporation is called the Stock for Assets tax-free transaction. This transaction is required to meet two federal tax code requirements. First, at least 80% of the considerations from the buyer need to be in stock. Second, the buyer must acquire almost all of the target company's assets. Like the taxable asset transaction, the buyer can deduct the depreciation of the acquired assets.

D) Type D Reorganization

Type D transaction is a transaction that puts the shareholder's interest first. Shareholders receive different holdings of stocks as a compensation for the merger deal. There are two types of Type D transaction, the acquisitive transaction and the divisive transaction. With the acquisitive transaction, the deal is proposed by one corporation in exchange for the entire assets and stocks of the target company. This form of transaction is the opposite of the Stock for Assets tax-free transaction, in that the buyer is now the one that is acquired by the target company. The tax implication is exactly the same as it is with a Stock for Assets tax-free transaction.

Divisive reorganization is another Type D transaction in which the corporation splits up and distribute stocks to the shareholders either in the same proportion, or the spin-off divisive reorganization, or at a different proportion as the stockholders hold at the original company, also called the split off divisive reorganization. If the shareholders are distributed with different proportion of stock, then the original corporation is dissolved.

E) Recapitalization

Recapitalization is a reorganization of the stocks between the buyer and the target company, as the buyer proposes the acquisition deal. Most of the reorganization focuses on the exchange of preferred stocks versus common stocks between the two companies. There is no specific advantage or disadvantage of this reorganization as it compares to the previous reorganization styles. It is simply a recapitalization of the stocks for the merged firm as a whole.

F) Change in Name, Form

This type of reorganization is simply a shift of the name and form of the target company to the buyer's name. There is no specific implication to this tax-free transaction because the target is not realizing any gains from the deal.

G) Reorganization as part of a bankruptcy

This tax-free transaction is a pure reorganization of a company under terms of bankruptcy. The buyer agrees to buy the bankrupted the target company, along with some of the target's liability and assets. This is similar to the recapitalization of the merged companies, but the structuring is in the forms of debt, assets, liabilities, and stocks.

Conclusion

The majority of the Mergers and Acquisition by public-held corporations are taxable due to the efficiency of the transaction as well as the absence of registration with Securities and Exchange Commission. Taxable reorganization often requires the use of cash as part of the consideration, which simplifies the complexity of the acquisition deal between the two companies. Most privately held corporations prefer the tax-free transactions due to the attractiveness of paying less tax as well as the involvement of fewer shareholders. From a business standpoint, as long as both companies create synergy after the merger, then the choice of a taxable or a tax-free transaction can be selected according to how they fit each company's situation.

nice write up
good interpretations

Work Cited

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Averaae Ratio for The Maior firms for the three industries

	EPS	Growth	Price-Earnings	Debt-Equity	Quick Ratio
Communication	26.39	17.86	26.39	1.82	1.24
Financial Services	6.77	7.84	20.80	4.30	0.72
Technology	17.90	8.90	17.90	0.52	1.35

correct interpretations

a bit staccato

not really a nice write-up.

OK analysis

Result:

1. Communication Industries:
   1) EPS of the industry is a lot higher than the sample companies. There might be some discrepancies with the EPS among the three industries.
   2) Growth Earnings: All of the transactions have higher growth rates than the industry. These companies might be expanding.
   3) Price-Earnings: All of the three M&A transaction have higher growth rates than the industry due to the technological advancement. It is a high potential growth industry.
   4) Debt-Equity: Most of the transactions have low DE ratio because these companies have more equities than debts as well as steady financial backgrounds. .
   5) Quick Ratio: The communication industry has a higher quick ratio than the three sample companies. Since the three companies have stable financial backgrounds, the quick ratios are lower than the average firms.

2. Financial Services:
   1) EPS: On average, the industry's EPS is higher than the selecte M&A
   2) Growth- Most of the M&A transactions have a relatively high Growth ratio than the industry's. This might due to the global exposures of each company.
   3) Price Earnings: Most of the transactions have a lower PE ratio than the industry due to a more mature level of growth.
   4) Debit Equity ratio: Financial Services usually lends a large amount of money to the customers From the data, the Investment Services Industry has a higher DE ratio than the regional banks due to their global exposures and a diversified client
   5) Quick Ratio: These mergers have higher quick ratio than the industry. This is because by looking at the characteristics and the financial statements of these banks, most of them have a pretty high quick ratio to pay off current liabilities.

3. Technology
   1) EPS: Usually, the technology industry as a whole has a high EPS. However, trom the data, these transactions in the technology industry have a low EPS.
   2) Growth: Technology sector generally has a high growth rate. From the data, each individual company is growing at a much higher paste than the industry. This might also due to the global exposures of each firm.
   3) Price Earnings: The industry's PE ratio is closer to the PE ratio of both Compaq Computer and Digital Equipment. However, the PE ratio between the industry and the mergers of Ascend/Cascade Communication have a huge differences. The reason might be that Ascend is buying out Cascade Communication to expand their business.
   4) Debt-Equity Technology sector itself has a low Debt to Equity ratio because the firms have a lot of assets to develop new technologies. Therefore, the firms do not have to finance their activities if they have a steady cash flows.
   5) Quick Ratio: The firms have a higher Quick ratio than the industry because the have a lot of current assets that can quickly pay off current liabilities.

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Mergers and Acquisition

Note: This is the Before-Merger Data. I don't have the after merger data since a lot of the companies have not compiled a complete Financial Statements Yet.

	Companies	Industry	Sector	EPS	Growth	Price-Earnings	Debt- Equity	Quick Ratio
1	WorldCom	Communication Services	Services	0.16	50.76	288.97	0.57	0.75
	MCI Communications	Communication Services	Services	-0.2	43.62	61.93	0.36	0.64
2	First Union Corporation	Regional Banks	Financial	2.47	14.78	20.39	0.94	1.12
	CoreStates Financial	Regional Banks	Financial	3.8	17.25	13.14	0.92	0.19
3	Compaq Computer Corp.	Computer Hardware	Technology	-1.58	23.42	19.38	0	0.95
	Digital Equipment Corp.	Computer Hardware	Technology	3.58	34.2	15.82	0.21	1.38
4	Morgan Stanely Group	Investment Services	Financial	6.45	44.06	6.4	5.96	1.04
	Dean Witter	Investment Services	Financial	5.04	22.38	12.96	4.09	1.11
5	AT&T	Communication Services	Services	26.65	51.65	26.65	0.3	1.16
	TCI Group	Broadcasting & Cable TV	Services	0.29	64.91	29.13	9.35	0.69
6	Travelers Group	Insurance	Financial	12.36	16.03	3.26	2.39	0.96
	Salomon Inc.	Investment Services	Financial	7.14	1.04	5.31	23.53	1.09
7	Ascend Communications	Computer Networks	Technology	1.03	64.08	46.6	0	0
	Cascade Communications	Electronic Instruments & Controls	Technology	1.52	64.65	7.125	0	3.59
8	Banc One	Regional Bank	Financial	2.88	7.41	15.52	0.91	1.14
	First Union Corporation	Regional Bank	Financial	5.85	14.78	9.51	0.94	1.12
9	Ameritech Corporation	Communication Services	Services	3.12	0.82	15.72	0.82	0.52
	SBC Communications	Communication Services	Services	1.78	58.69	22.24	1.27	0.55
10	Travelers Group	Insurance	Financial	12.36	16.03	3.26	2.39	0.96
	Citicorp	Money Center Banks	Financial	7.93	4.86	12.7	0.93	1.15

Student: Alice Chung

Topic: Tax Issues with regards to mergers and Acquisition

Faculty Comments:

The discussion of tax issues related to mergers and acquisitions is a nice write up of the rules pertaining to mergers and acquisitions. It is evident that the student spend a significant amount of time reading up on the topic and discussing the issues with experts.

The computation of financial ratios for the firms that engaged in merger and acquisition activities are done correctly as is the computation of industry averages. Further, the conclusions are appropriate. The only backdraw on the paper is that the write up of the comparison of the merger/acquisition firms and the industry appear somewhat staccato.

Other comments are written on the research report.