1961

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Recommended Citation
Haskins & Sells Selected Papers, 1961, p. 287-295

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Some Tax Problems in Connection with Acquisitions

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Presented before the Association for Corporate Growth and Diversification, Inc., New York—September 1961

When starting to talk about tax planning in connection with acquisitions we are in an area of almost unlimited possibilities. I am therefore going to try to brush over some parts of this area, and in so doing hope to hit on a few things that may present a fresh viewpoint to some of you.

When starting to think of what should be regarded as tax problems in an acquisition, we must first consider what the parties concerned really want. What does the seller want? What does the buyer want? What problems are particularly important because the acquisition is in the offing and how are they to be solved? Our method of solving them is largely dependent on the objectives of the parties to the transaction.

There are so many possibilities that we just cannot even think of drawing conclusions without taking note of all the facts. So obtaining the facts, finding out what the situation really is, is the first thing we should start doing. Of course we can't give all the pertinent facts in a discussion of this nature but we can introduce a few of them as we go along.

Now, let us look at some rather basic considerations. The theory of having provisions for nontaxable or partially taxable transactions in the Internal Revenue Code is for the primary purpose of enabling businesses, without adverse tax consequences, to enter into realistic business reorganizations that have legitimate business purposes and are not primarily or solely for tax purposes. In such situations recognition of gain or loss is postponed until such time as the acquiring company has really sustained an economic loss. There are several basic kinds of tax deferments or special tax-treatment provisions with which we may work. We have reorganization exchanges with which all of us are familiar. Just in case some of them may have receded too far into the background for ready recollection, perhaps I should mention the kinds of things with which we should all be basically familiar.
TAX-FREE TRANSACTIONS

First are statutory mergers or consolidations. Next are exchanges of voting stock where the parties to the reorganization have control of the acquired corporation following the acquisition. Then come transactions calling for the exchange of voting stock of the acquiring corporation or its parent for substantially all of the assets of a corporation. Finally, we have transactions calling for the transfer of all or part of the assets to another corporation, the transferor or its stockholders remaining in control after the transfer and the stock of the corporation to which assets are transferred then being distributed in accordance with the plan of reorganization. These are the typical nonrecognition reorganization exchanges. Of course, there are also tax-free recapitalizations, changes in identity, or changes in form or place of incorporation.

Now, there are some other kinds of special tax-treatment exchanges that are not really reorganizations. One that we do not use very often—and probably not often enough—is the tax-free exchange of property, held for investment or used in business, for like property. In connection with an acquisition we may not be interested in acquiring the whole company but only a particular part of its property. If the purchaser isn't interested in inventory stock, or securities, we may be able to figure out some way of obtaining assets that the seller would like to have and that he would be willing to receive in exchange for the property in which we are interested. It is quite possible that it is a particular location in which we are really interested, and we may find that this particular seller would be just as willing to have other property, such as an apartment house. We may have problems of finding property of like-kind susceptible to such an exchange but we shouldn't forget to consider the possibility of a like-kind exchange if we are only looking for part of the assets.

TAX CONSIDERATIONS IN AN ACQUISITION

Now, of course, the basic things we must consider in any acquisition are, as I said earlier: What do the parties really want? What does the seller want? What does the buyer want? We may be in a situation where the seller will not let us have the particular assets we desire without selling us the whole thing and he may want to sell us his stock. He may not be willing to sell just the assets. If
this is so, then we must really look at the company itself and see what we are getting—see what the tax exposure of that company is. What kind of tax problems does it carry with it? Are there prior years that have not been examined by the Internal Revenue Service? What kind of problems are we most likely to face if we acquire the stock?

EVALUATION TAX STATUS

Let's consider a company that does not have widespread stock ownership, for this is quite often the kind of company we are apt to be looking at, and I think the problems usually are greater in this type company than they are in a publicly held corporation.

First, we should consider whether or not the travel and entertainment expenses that have been claimed by the corporation are reasonable. This is an area the Internal Revenue Service is attacking quite hard at the present time. One of the big questions that frequently arises is in connection with the salaries of officer-stockholders. Are they reasonable? Are there problems in connection with the company's pension plans and profit-sharing plans? Has the profit-sharing or pension plan for some reason or another become disqualified under the Internal Revenue Code so that the contributions made or required to be made by the company are no longer deductible? What kind of liability does the company have under employment contracts? Is the liability one that when discharged will be deductible for tax purposes or is it one where we might have to capitalize the cost? Have there been repairs charged off that really should have been capitalized? Is the company a personal holding company or does it have any possible liability for the personal holding company surtax? What is its exposure with respect to unreasonable accumulations of surplus? The last-mentioned point can be a significant problem in a small, closely held corporation. Does it have a bad-debt reserve (if it is using a reserve method) that on liquidation of the corporation at some subsequent time may result in income to the corporation? Has it had changes in its accounting methods or in its fiscal year without bothering to get permission from the Commissioner of Internal Revenue for such changes? Is it a small-business corporation? Has an election been made? If it has, we may have all kinds of tax problems on hand. What is the exposure for prior state and local taxes in the various places where it has been operating? There may be special problems in situations relating to installment receivables. Does each significant
asset represent something that has full-cost basis for tax purposes or is it something where we have to pay a tax in order to realize dollars? These, of course, are matters that enter into our negotiations but they should not be overlooked.

WARRANTY AGAINST TAX LOSS

Many people think that in negotiating an acquisition the real answer to the tax problem is a warranty against all prior tax liability. Maybe the seller isn’t very anxious to give a guaranty. The seller having given the guaranty would then be in a position of relying on someone else to fight his tax case for him. I have seen the situation where the seller would only give the guaranty if he were given the privilege of having his own tax advisor approve any settlement of such tax liability arranged after the time he is no longer in control. In a good many situations even where the seller does give the guaranty there are costs in fighting these proposed tax deficiencies. In the negotiations for the acquisition, have these costs been considered? These are just some of the tax matters to be looked for and evaluated if stock is to be acquired.

ACQUISITION METHODS AND TAX EFFECTS

The next area to consider is that of putting the organization together. How are we going to acquire it in such a way that we obtain advantages tax-wise along with maintaining the business purposes of our acquisition—to fit the needs and desires of both the buyer and the seller? Suppose we have a situation where the seller doesn’t want to recognize any gain at all. He wants to exchange his stock for stock in the acquiring company. This can be very simple. We have to be sure, of course, that we get all or almost all of the stock of the acquired company. But we have acquired stock.

PURCHASE OF ASSETS

If we assume that the company to be acquired will cost considerably more than the net book value of the assets and the entire company is to be acquired, the buyer may wish to have a stepped-up cost attributed to the assets for depreciation and amortization purposes. Perhaps the sellers (stockholders of the company to be acquired) do not want to recognize taxable gain or, if they do, they are concerned
with a sale of the assets of the corporation. Assuming first that the sellers are willing to recognize a taxable capital gain to the extent of the difference between the cost basis of their stock and the price being paid, there are methods for accomplishing this either through the purchase of the assets or through the purchase of their stock. The sellers could adopt a plan of liquidation calling for a complete liquidation within one year. The desired assets of the company would be sold to the buyer during the one-year period and the liquidation then completed. Even inventories can be bulk-sold in such a situation without the corporation’s realizing a taxable gain. The sellers would realize their gain on the liquidation so that only one tax on the gains would be paid. This method is particularly desirable in situations where not all the assets are being acquired and where certain liabilities cannot reasonably be transferred to the buyer. Timing is important. Care should be exercised to avoid an informal adoption of a plan of liquidation. From the standpoint of the selling stockholders, a possible disadvantage is that the entire gain is taxable in the taxable year or years of the stockholders within which they receive the distributions in liquidation. If in the alternative a sale of the stock were made using the installment method, then gain could be deferred at least in part. Further, certain installment receivables could not be qualified for purposes of eliminating taxable income to the selling corporation.

The seller may not want to go ahead and complete the liquidation. He may prefer to have his corporation pay tax on what gains are realized and to have it remain in existence. This may involve it in becoming a personal holding company, however. One of the methods that some people have been using to take their companies out of the position of being personal holding companies and to get more liquid securities in the owners’ hands after sale of all major assets, is to exchange the stock in the company (which by then has cash, receivables from the buyer, and a few other assets) for stock in a regulated investment trust. This is a current practice but just a word of caution. The Internal Revenue Service is now refusing to give rulings with respect to this sort of transaction. Their refusal does not mean the transaction is not good—it just means the Service will not give a ruling with respect to it. I think the Code says the same thing as it did when the Service was giving rulings in this area. Nevertheless, the fact that the Service will no longer rule should be carefully considered before that procedure is used.
PURCHASE OF STOCK

If the sellers for one reason or another do not want to proceed with the methods described above, then it is possible for the acquiring company to accomplish its objective of establishing the step-up in cost basis even though stock is acquired instead of assets. This calls for acquisition by the acquiring company of at least 80 per cent of the voting power and at least 80 per cent of the number of shares of all other classes of stock (except nonvoting stock that is limited and preferred as to dividends). The stock must be acquired within a period of not more than twelve months and must be acquired by purchase. Then the acquired corporation (which then is a subsidiary) is liquidated into the parent within two years following the last purchase of stock. In this way the transaction is considered as purchase of assets and the purchase price is allocated among the assets in proportion to their fair market value.

If this method is used it is desirable to consider having the liquidation occur as soon as possible after the acquisition. The indications are that the Internal Revenue Service will make an adjustment to cost basis for the extra depreciation that would have been allowed had the liquidation occurred at the first date it could have been accomplished. For example, if the depreciable assets have a ten-year remaining life, would have a step-up in basis from $100 to $200, and the liquidation does not occur until almost two years after the acquisition of the stock, two-years' depreciation on the excess basis or $20 may be lost completely. This approach may not be correct, but it is provided for in the regulations.

Another problem not to be overlooked in connection with this method of acquisition is: What portion of the cost must be appropriately allocated to goodwill and other intangibles not susceptible to depreciation or amortization for tax purposes? The Internal Revenue Service is looking quite carefully into possible goodwill in connection with this type of transaction. Goodwill is a problem even if assets are acquired directly from the selling company but my belief is that it is more of a problem where the stock is acquired by purchase and the acquired company liquidated into the purchaser. The Internal Revenue Service at the present time is making an effort, in situations where the acquiring company is attempting to get a step-up in cost basis, to assert that there was goodwill representing at least the amount of the excess of cost over the basis in the hands of the acquired
company. One of the things they are doing in this connection is considering the company's past history. A few minutes ago I mentioned some of the tax problems in the company that may be acquired. One of such problems the Service is considering is whether or not the salaries paid to stockholder-executives are excessive. If the Service feels they are, the deductions are not necessarily disallowed, but such excess is added back to income for the purpose of determining whether or not the acquired company actually had excess earnings; under the Service formula, excess earnings sustain the position that one of the assets acquired is goodwill. This is a point that should be carefully considered when acquiring a corporation with the expectation of getting a stepped-up cost basis.

As mentioned before, a point not to be overlooked is that an upward adjustment in basis of assets acquired in this manner is not the only adjustment that might be required. A downward adjustment may be indicated and the Code provision works both ways. A suggestion is that if the method has been followed or is about to be followed in most respects and the price being paid when allocated would result in a reduction in cost basis of depreciable and amortizable assets, then consideration should be given to deliberate non-compliance with one of the essential elements. For example, either the acquisition of the stock might be made over a period in excess of one year (perhaps a contract to purchase some of the stock instead of a contract of purchase, or use of options to purchase, might be considered), or the liquidation might be deliberately delayed beyond the two-year period.

PURCHASE OF STOCK IN OPEN MARKET

Suppose instead of being willing to accept a tax in connection with the disposition of their company, the stockholders do not want to recognize any taxable gain, and yet the acquiring company wants to obtain a step-up in cost basis of assets. There is a method that might be considered and there is one key point to success in accomplishing the desired objective. Except for that point the method calls for the normal use of the acquisition of the stock within one year and liquidation within two years. As the selling stockholders desire to have a tax-free exchange, it would require an exchange of stock of the acquiring company for all of the stock of the acquired company. What makes this a transaction wherein the basis can be stepped up? Normally it could not be, but the key is to have the acquiring cor-
poration purchase its stock in the open market and to use that stock for the acquisition. With respect to the sellers this should be a tax-free transaction and with respect to the buyers it should result in acquisition of the stock in the acquired company by purchase.\(^1\) (A word of caution: Have the method checked carefully before using it—the courts have not decided this issue under the 1954 Code.)

CARRYOVER OF ACCOUNTING METHODS

One tax point to be considered in connection with acquisitions that is often overlooked is whether or not accounting methods, such as that of computing depreciation allowances, will be carried over to the acquiring company. Other matters are also covered—carryovers of net operating losses, capital losses, accounting methods, etc. Of course, if the acquired company continues in existence, and retains its depreciable assets, the problem will not arise. It is generally where the assets are acquired in such a manner that a step-up in cost basis is realized that loss of carryovers occurs. Suppose, for example, that the assets, or a large part of the value thereof, have been acquired recently by the acquired company and one of the rapid methods of depreciation is being used. If the assets have long lives, the purchaser may not want to lose the possibility of using the same method of depreciation in use by the seller. In order to obtain the carryover of method, the acquisition must technically qualify as a reorganization and must not be a purchase or an acquisition of the stock of the acquired company solely for voting stock of the acquiring company.

\(^1\) In the questions-and-answer session, all questions from the group pertained in one way or another to the obtaining of a stepped-up cost basis of assets after an acquisition of stock. In order to qualify for the special treatment under Section 334(b)(2) of the Internal Revenue Code of 1954, it is necessary that the stock be acquired by purchase. *Purchase* is defined in Section 334(b)(3).

I believe it is desirable, where we are trying to obtain a tax-free exchange for the seller and a stepped-up-cost basis to the buyer, to be very careful about what is done with the purchased stock of the acquiring corporation. The intention of a purchase in the open market for cash is to establish a cost basis for the stock in the hands of the acquiring corporation. I suggest specific identification of the stock so acquired (which will be used for the acquisition) and the avoidance, if possible, of consideration of such stock as treasury stock. It is important that this stock not be considered as issued in exchange for the stock of the acquired corporation. The case of *Firestone Tire & Rubber Co.*, 2 TC 827 (acquiesced, 1945 CB 3), is in point, but is a pre-1954 Code decision. In view of the uncertainties existing if and when you are considering the possibility of using this method, it should be checked out in advance with your tax counsel. This method may be very beneficial in a situation where you want to go through with the acquisition irrespective of whether or not you obtain the stepped-up cost basis.

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RECAPITALIZATION

Many acquisitions may present situations wherein a recapitalization may be used to good advantage. Often the stockholdings of a company are spread among stockholders who are interested in the growth of the organization and others who would like secure income. This latter might be the case with respect to estates and trusts. Frequently where a death of a substantial stockholder in the company to be acquired has recently occurred, not only will the executors and trustees prefer senior securities, but also the stock held by them will have a cost basis that has been established at the date of death (or one year thereafter). This stockholder may not be particularly concerned with whether or not the transaction is a taxable transaction so long as it does not constitute a dividend. Giving due respect to the problems that might arise in step-transactions, it may be desirable to have the corporation to be acquired recapitalize, giving senior securities to the trust or estate and voting common to the remaining stockholders before the acquisition by the acquiring corporation.

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Each case must be considered on its own merits. Careful planning in the early stages is very important, but again I want to emphasize that we should always bear the risk factor in mind and be sure that everybody concerned is willing to take what risks are being taken in order to accomplish the objectives they hope for.