KNOWING WHAT YOUR BUYER IS THINKING - A BUYER'S ANALYSIS FOR BUYING YOUR BUSINESS[†]

ALTERNATIVE METHODS

Although the methods used to effect acquisitions will vary depending upon the objectives of the parties, all acquisitions have certain basic elements in common. First, an acquisition almost always has one party who is clearly identifiable as the Acquirer and one party who is clearly identifiable as the Target. Second, one may always characterize acquisitions by simply identifying what it is that the Acquirer is purchasing. In an asset acquisition, the Acquirer purchases from the Target all assets necessary for the continued conduct of that business. In a stock acquisition, the Acquirer does not purchase the desired business directly from the Target but rather purchases it indirectly by acquiring all of the outstanding voting securities from the Target's stockholders. An asset acquisition gives the Acquirer direct ownership of the business assets while a stock acquisition results in an indirect ownership of the assets by virtue of owning the Target's voting stock. Because the manner by which the Acquirer exerts ownership varies, it is appropriate to review the implications of direct and indirect ownership of the acquired business before discussing the available methods to achieve either.

In an asset acquisition, the Acquirer acquires only the assets specifically identified in the acquisition agreement between the Acquirer and the Target or referred to in the Target's financial statements attached to that agreement. Accordingly, the Acquirer, in an asset acquisition, eliminates any subsequent loss due to undiscovered or undisclosed liabilities attributable to the business. Further, because the Acquirer purchases the assets from the Target itself, the Acquirer receives no better rights to those assets than the Target may assert. The Acquirer must therefore examine the assets to determine that none is subject to any lien, mortgage, security interest or other encumbrance which would prohibit its transfer to the Acquirer. If any asset is so subject, the encumbrance must be removed or the consent of the party asserting it must usually be obtained before the Target can transfer unencumbered title in the assets to the Acquirer. Similarly, the Acquirer must examine all contractual relationships essential to the business to determine that the Target may freely assign them to the Acquirer without the necessity of the Target's obtaining any consent from the other parties to those contractual relationships.[1] If any consent is necessary, the Acquirer should insure that the Target obtains that consent prior to the consummation of the acquisition in order to allow for the uninterrupted continuation of the business at no additional cost to the Acquirer. Should any necessary consents prove impossible or too costly to obtain, the Acquirer should consider instead the acquisition of all of the voting securities of the Target in a stock acquisition.

In a stock acquisition, the Acquirer purchases, through its acquisition of the Target's voting securities, the corporation rather than the underlying assets of the corporation. Because the stock acquisition does not

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[†] When this article was written in 1988, acquisitions could be accounted for under either the pooling of interests method or the purchase method. See notes 35-51, infra, for an explanation of the circumstances in which each accounting method was to be used. Effective June 30, 2001, all acquisitions must be accounted for under the purchase method of accounting. See Statement No. 141, Accounting for Business Combinations, Financial Accounting Standards Board (2001). Effective December 15, 2001, goodwill is no longer to be amortized over a period of forty years. Instead, goodwill remains unamortized on the acquirer's balance sheet, subject only to the obligation of the acquirer to perform periodic impairment tests and write down goodwill if the fair value of the acquirer as a reporting unit falls below its carrying value. See Statement No. 142, Accounting for Business Combinations, Financial Accounting Standards Board (2001).

[1] Significant contractual relationships to examine include leases of real and personal property, technology licenses, customer contracts and marketing agreements.

affect the Target's ownership of the assets used in its business, the Acquirer encounters no difficulties regarding the transfer of encumbered assets or the assignment of essential contractual relationships. For the same reason, however, the Target's assets, now indirectly owned by the Acquirer because of its ownership of the Target's voting securities, remain subject to all liabilities of the Target's business, including all undiscovered or undisclosed liabilities. If a large number of stockholders hold the Target's voting securities, the Acquirer will likely experience difficulty in obtaining a consensus among the stockholders as to the precise language of the acquisition agreement which will protect the Acquirer against any undiscovered or undisclosed liabilities as well as any other legal concerns. In any proposed acquisition, then, one must weigh the degree of difficulty in dealing with multiple stockholders against the effort and expense to effect the transfer of unencumbered assets and essential contractual relationships in order to decide whether to obtain ownership of the desired business by purchasing stock or assets.

With this information, the Acquirer is now ready to examine the following six different methods of obtaining ownership of the Target's business:[2]

Asset Purchase. The simplest asset acquisition, as described above, involves the Acquirer's direct purchase of the desired assets from the Target in exchange for cash, other property or the Acquirer's stock. The Acquirer and the Target enter into an asset purchase agreement in which the Target conveys title to the desired assets, assigns essential contractual relationships, and makes certain guaranties, representations and warranties with respect to the business being transferred.

Merger. Assuming that both the Acquirer and the Target are corporations, a second acquisition method involves the Target's merger into the Acquirer with the Acquirer remaining as the surviving corporation. The Target's stockholders receive cash, the Acquirer's stock or other property in consideration for their shares of the Target, and the Target ceases to exist. The merger of two corporations is a concept created by state law, and the Acquirer and the Target must comply with the laws of their respective states of incorporation to effect the merger.[3] The Acquirer and the Target enter into a merger agreement setting forth all terms of the merger, including the consideration to be received by the Target's stockholders as well as certain representations and warranties regarding the Target's business.[4] The approval of the boards of directors and the vote of the stockholders of both corporations are generally necessary to approve the merger.[5] As the result of a merger, the Acquirer, as the surviving corporation, as a matter of law succeeds to all of the Target's rights, duties and obligations without the need for any further action on the part of either corporation.[6]

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[2] The Acquirer's purchase of the outstanding voting securities of a publicly held Target by means of a tender offer is beyond the scope of this article. Similarly, a consolidation of Acquirer's and Target's businesses into a new corporation will not be discussed because merger is the predominant statutory mechanism used to effect acquisitions.

[3] See, e.g., DEL CODE tit. 8. §§ 251 -253.

[4] It is important to note that most merger agreements provide that the merger will be consummated at a date subsequent to the date of the agreement only upon fulfillment of certain conditions by the parties. One such condition is the continued accuracy of the representations and warranties as to the Target's business. It is incumbent upon the Acquirer to conduct a thorough investigation of the Target's business during the period between the date of the merger agreement and the date upon which the merger is expected to be consummated. Once the merger is consummated, the economic risk of the Target's business is shifted to the Acquirer, and the Acquirer has no recourse against anyone for the failure of any representation or warranty because the other party to the merger agreement (the Target) no longer exists.

[5] See, e.g., DEL,. CODE tit. 8, § 251(b)-(c). Section 251(b) requires the adoption by the respective boards of directors of resolutions approving the merger agreement. Section 251(c) requires the vote of the holders of a majority of the outstanding stock of a Delaware corporation to approve the merger. Any stockholder not voting in favor of the merger may be entitled to receive the appraised value of his shares. Id. at § 262.

[6] See, e.g., DEL CODE tit. 8, § 259.

Triangular Merger. In the third acquisition method, the Target merges into a controlled subsidiary of the Acquirer (Sub). The Sub remains as the surviving corporation, and the Target ceases to exist. The Target's stockholders receive cash, stock of the Sub or the Acquirer or other property in exchange for their shares of the Target.[7]

Stock Purchase. Under the fourth method, the Acquirer purchases the Target's outstanding voting securities directly from the Target's stockholders in exchange for cash, the Acquirer's stock or other property. The Target thus becomes a wholly-owned subsidiary of the Acquirer. The Acquirer and the Target's stockholders execute a stock purchase agreement in which the stockholders sell their shares in the Target to the Acquirer and make certain guaranties, representations and warranties regarding the Target's business.

Reverse Merger. A fifth acquisition method involves the Acquirer's merger into the Target. The Target remains as the surviving corporation, and the Acquirer ceases to exist. The Target's stockholders receive cash or other property in exchange for their shares of the Target or, in the alternative, receive shares of the Target as the surviving corporation in exchange for their shares in the pre-merger Target. The Acquirer's stockholders receive a sufficient number of the Target's shares in exchange for their shares of the Acquirer to enable them to exercise control over the Target. Because the Target succeeds to all of the Acquirer's rights, duties and obligations with respect to Acquirer's business as a result of the merger, the Acquirer's business remains intact but is carried on under a different corporate umbrella and in conjunction with the pre-merger Target's business.[8]

Reverse Triangular Merger. In the final acquisition method, the Sub merges into the Target. The Target remains as the surviving corporation, and the Sub ceases to exist. The Target's stockholders receive cash, the Acquirer's stock, post-merger Target shares or other property in exchange for their pre-merger shares in the Target, and the Acquirer receives a sufficient number of the Target's post-merger voting securities to allow the Acquirer to exercise control over the Target. The Target becomes a controlled subsidiary of the Acquirer.

Each of these six acquisition methods has identifiable tax and accounting effects, and the financial implications arising from them necessarily influence the acquisition method chosen. One is now prepared to explore these effects in order to gain the working knowledge necessary to make an informed choice of a method which will allow the Acquirer to achieve its business objectives.

TAX EFFECTS

One may characterize all acquisitions as either taxable or nontaxable transactions to the seller, regardless of whether the seller is the Target or the Target's stockholders. Taxable transactions involve the Acquirer's direct acquisition of assets or stock by purchase or a deemed acquisition of assets or stock by merger. The amount of gain realized and subject to taxation in a taxable transaction is the difference between the fair market value of the consideration received from the Acquirer and the seller's basis in the assets or stock conveyed.[9] In an asset acquisition, the tax is assessed against the Target because it is the

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[7] The discussion of mergers set forth under Merger above is equally applicable to mergers involving the Target and the Sub.

[8] It is important to note that most indentures, bank loan agreements, security agreements and similar documents to which many prospective Acquirers are parties either prohibit such mergers or allow them only upon fulfillment of certain well-defined conditions.

[9] I.R.C. § 1001.

Target who receives the purchase price from the Acquirer.[10] If the Target then liquidates and distributes the proceeds of the acquisition to its stockholders, the stockholders are taxed on the difference between the amount received in liquidation and their respective bases in the Target's stock. In a stock acquisition, only the Target's stockholders are responsible for payment of tax because they receive the purchase price directly from the Acquirer. If the transaction is to be taxable to the seller, present tax law favors the stock acquisition because it allows the Target to avoid. tax.[11]

Nontaxable transactions involve the direct acquisition of assets or stock by the Acquirer or its Sub in consideration for the securities of the Sub or the Acquirer or, in the alternative, a deemed purchase of assets or stock in exchange for the securities of the Sub or the Acquirer by merger. There are three types of acquisitions which are nontaxable to the seller.[12] The first type of nontaxable acquisition is the merger in which the Target's stockholders receive stock of the Acquirer or the Sub or, in the case of the reverse merger, post-merger shares of the Target, in exchange for their shares of the Target.[13] A second form of nontaxable acquisition involves the issuance of voting stock of the Sub or the Acquirer for at least 80% of the Target's stock.[14] The third alternative for effecting nontaxable acquisitions is the issuance of voting stock of the Sub or the Acquirer for substantially all of the Target's assets.[15] While taxability is of primary concern to the Target and its stockholders, the Acquirer should also have more than a passing interest in this issue. The acquisition's taxability to the seller can affect the Acquirer's tax basis in the property acquired, with a resulting impact on the Acquirer's taxable income subsequent to the acquisition as certain of these assets are depreciated or amortized. The amount of depreciation or amortization which the Acquirer will

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[10] Prior to August 1, 1986, a corporate Target could, subject to certain exceptions, avoid taxation on the proceeds of an acquisition by adopting and implementing a plan of liquidation under Section 337 of the Internal Revenue Code. Section 337 provided that proceeds of an acquisition would be taxed only once when they were distributed to the Target's stockholders In liquidation. Section 337 was repealed by the Tax Reform Act of 1986.

[11] As will be subsequently discussed, the Target may be subject to tax in connection with the acquisition should the Acquirer desire to obtain a basis in the Target's assets equal to their fair market value. The Acquirer may obtain this "stepped up" basis by electing to treat the acquisition as one made under Section 338 of the Code. Prior to January 1, 1987, an Acquirer's Section 338 election resulted in the acquisition's being deemed a sale of assets in a transaction under Section 337 with the Acquirer’s taking a tax basis in the acquired assets equal to their fair market value. While Section 338 remains available to any Acquirer desiring to obtain a stepped up basis in assets received pursuant to a stock acquisition, the repeal of Section 337 causes tax to be imposed on the difference between the Target's pre-acquisition tax basis in its assets and the fair market value of those assets as evidenced by the purchase price negotiated in the acquisition. Although this tax would be imposed upon the Target, the economic risk for the payment of this tax would be borne by the Acquirer because, as a result of the acquisition, the Target is now a wholly-owned subsidiary of the Acquirer.

[12] The three types of nontaxable acquisitions are described in Section 368(a)(1)(A)-(C) of the Code. A fourth type of reorganization described in Section 368(a)(1)(D) will not be discussed in this Article since it requires that the Acquirer's stockholders surrender control of the Acquirer in order to consummate the acquisition of the Target's assets. All nontaxable acquisitions effected under Section 368(a)(1)(A)-(C) must have a valid business purpose, continue the Target's historic business enterprise, and provide the Target's stockholders with a continuing ownership in the combined operation. Treas. Reg. § 1.368-1 (b)-(c).

[13] I.R.C. § 368(a)(1)(A). If property other than voting stock or securities (boot) is transferred to the Target's stockholders to effect a statutory merger, the stockholders will be subject to taxation on the amount of the gain to the extent of the boot received in accordance with Code Section 356(a).

[14] I.R.C. § 368(a)(1)(B). The Acquirer must, under this provision, be in control of the Target immediately after the acquisition. Control is defined as the ownership of 80% of the Target's voting stock and 80% of all other classes of the Target's stock. I.R.C. § 368(c)(1).

[15] I.R.C. § 368(a)(1)(C).

experience for tax purposes is a function of the basis which the Acquirer takes in the Target's assets.

The basis of property acquired from a seller is generally the cost of that property.[16] For tax purposes, the Acquirer values assets acquired from the Target in a taxable acquisition at their cost (Cost Basis). Similarly, when the Acquirer purchases the Target's stock from its stockholders in a taxable acquisition, the Acquirer values that stock at its cost for tax purposes. However, the Target's basis in its assets is unaffected because it is the Target's stock and not its assets which is conveyed in a stock acquisition. The basis of the Target's assets before the acquisition continues to be the basis of those assets after the acquisition (Carryover Basis).[17] While the Acquirer can elect to obtain a Cost Basis in the Target's assets after the Acquirer's purchase of the Target's stock, the Acquirer must pay tax on the difference between Cost Basis and Carryover Basis if it so elects.

The general rule that the basis of acquired property is its cost is subject to exceptions. When the Acquirer buys the Target's assets in a nontaxable transaction, the Acquirer takes a Carryover Basis in the assets.[18] In a nontaxable stock acquisition, the Acquirer takes a Carryover Basis in the stock received from the Target's stockholders.[19] As is the case with a taxable stock acquisition, the Target's basis in its assets is not affected by the nontaxable stock acquisition, and those assets retain their Carryover Basis.[20] Because the typical acquisition involves the Acquirer's transfer of property with a value in excess of the Carryover Basis of the Target's assets, it is more beneficial for tax purposes for the Acquirer to take a Cost Basis in the acquired assets than a Carryover Basis. If the Acquirer can allocate any excess of Cost Basis over Carryover Basis to depreciable or amortizable assets, the Acquirer's taxable income subsequent to the acquisition is less when the Acquirer structures the acquisition to obtain that Cost Basis.

The effect of the chosen acquisition method on the Acquirer's ability to obtain a Cost Basis or a Carryover Basis in the Target's assets may best be understood by examining each of the six different acquisition methods as both taxable and nontaxable transactions. The Acquirer or its Sub, as appropriate, takes a Cost Basis in the Target's assets acquired in a taxable acquisition which is either an asset purchase,[21] a merger,[22] or a triangular merger.[23] The Target's assets retain their Carryover Basis in a taxable acquisition effected

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[16] Treas. Reg. § 1.1012-1(a).

[17] N. W. Pugh Co.. Inc. v. Helvering, 70 F.2d 776 (D.C. Ctr. 1934), cert. denied, 293 U.S. 575.

[18] I.R.C. § 362(b).

[19] Id.

[20] N. W. Pugh Co.. Inc. v. Helvering, 70 F.2d 776 (D.C. Cir. 1934), cert. denied, 293 U.S. 575.

[21] Treas. Reg. § 1.1012-1(a).

[22] Id. The Internal Revenue Service (IRS) treats a taxable merger as the Target's sale of assets followed by the Target's liquidation. West Shore Fuel, Inc. v. United States, 598 F.2d 1236 (2d Cir. 1979). See Rev. Rul. 69-6. 1969-1 C.B. 104. Mergers consummated without the use of the Acquirer's stock have been held not to qualify as non-taxable transactions because the Target's stockholders have no continuity of interest in the surviving corporation. Cortland Specialty Co. v. Comr., 60 F.2d 937, 939 (2d Cir. 1937), cert. denied, 288 U.S. 599 (1932). Although no minimum standard has been established for the amount of the Acquirer's stock which must be issued in order for a merger to qualify as a nontaxable acquisition, the IRS has stated it would consider continuity of interest to exist if the Target's stockholders receive Acquirer's stock with a value of 50% of the value of the Target's stock surrendered in the merger. Rev. Proc. 77-37. 1977-2 C.B. 568.

[23] Ltr. Rul. 7929045; Ltr. Rul. 7851014. See also Treas. Reg. § 1.1012-1(a). The IRS deals with a taxable triangular merger as the Target's sale of its assets to the Sub followed by the Target's liquidation and its distribution of all property received in the merger to its stockholders. Ltr. Rul. 7929045; Ltr. Rul. 7851014.

as either a stock purchase,[24] a reverse merger,[25] or a reverse triangular merger.[26]

The Target's assets retain their Carryover Basis after every nontaxable acquisition, regardless of the method by which the Acquirer consummates its acquisition. So, the Acquirer takes a Carryover Basis in a nontaxable acquisition effected by means of either an asset purchase[27] or a merger of the Target into the Acquirer.[28] It is the Sub which takes a Carryover Basis in the Target's assets in a nontaxable triangular merger, regardless of whether the Target's stockholders receive the Sub's stock[29] or the Acquirer's Stock[30]

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[24] N. W Pugh Co.. Inc. v. Helvering, 70 F.2d 776 (D.C. Cir. 1934), cert. denied, 293 U.S. 575. The Acquirer may obtain a Cost Basis in the Target's assets by making the election to treat the stock purchase as a qualified purchase under Section 338 of the Code. However, due to the changes made by The Tax Reform Act of 1986, the Acquirer is now taxed on the difference between the Carryover Basis and the Cost Basis. See note 11, supra, for a discussion of the Section 338 election.

[25] When the Acquirer merges into the Target, the IRS treats the merger as a purchase of the Target's stock by the Acquirer's stockholders, with the Acquirer's stockholders receiving shares of the Target and the Target's former stockholders receiving other property. I.R.C. § 368(a)(2)(E). Although this Section describes the effects of a nontaxable reverse triangular merger rather than a taxable reverse merger, the difference between the two forms is not structure but is the nature of the consideration received by the Target's stockholders. When the consideration received by the Target's stockholders in exchange for the Target's pre-merger stock is property other than post-merger voting stock of the Target (or the Acquirer in the case of a reverse triangular merger), the transaction is taxable. When the consideration received is post-merger voting stock of the Target (or voting stock of the Acquirer in the case of a reverse triangular merger), the transaction is nontaxable. Legal research has revealed no cases or rulings in which the effects of a taxable reverse merger have been addressed. However, the analysis of a reverse merger as a stock purchase of the Target's stock by the Acquirer's stockholders has been supported by various commentators. See Tufts, The Taxable Merger, 7 J. CORP. TAX. 342, 344 (1981); Stone, Planning Cash and Other Non-Reorganization Mergers, 37 N.Y.U. INST. ON FED. TAX., Ch. 1, at 1-14 (1979). The Acquirer's stockholders take a basis in the stock of the Target acquired in the taxable reverse merger equal to the consideration received by the Target's former stockholders in the transaction. As in the case of the stock purchase described in note 24, supra, the Target's basis in its assets is unaffected by the sale of the Target's stock.

[26] The IRS treats the Sub's merger into the Target as a sale by the Target's stockholders of the Target's stock to the Acquirer. Rev. Rul. 73-427, 1973-2 C.B. 301; Ltr. Rul. 8016119; Ltr. Rul. 8015117. The Acquirer takes a basis in the stock of the Target in the transaction equal to the consideration transferred to the Target's stockholders. As in the case of the stock purchase described in note 24, supra, the Target's basis in its assets is unaffected by the sale of the Target's stock.

[27] I.R.C. § 362(b). Code Section 368(a)(1)(C) authorizes the nontaxable acquisition of substantially all of the Target's assets in exchange for the voting stock of the Sub or the Acquirer. "Substantially all" of the Target's assets has been defined as 90% of Target's net assets and 70% of Target's gross assets. Rev. Proc. 77-37, 1977-2 C.B. 568, 569. Although Section 368(a)(1)(C) requires that only voting stock of the Sub or the Acquirer be used to effect the acquisition, an exception has been created to allow the use of money or other property so long as at least 80% of the fair market value of all the Target's assets is acquired with voting stock of the Sub or the Acquirer. I.R.C. § 368(a)(2)(B).

[28] I.R.C. § 362(b). The IRS treats the merger as a sale of assets by the Target followed by the Target's liquidation and its distribution of all consideration received to the Target's stockholders. Rev. Rul. 75-161, 1975-1 C.B. 114.

[29] I.R.C. § 362(b). A merger of the Target into the Sub in which the Target's stockholders receive stock of the Sub is treated as a merger under Section 368(a)(1)(A). See note 28, supra.

[30] I.R.C. § 362(b). Like the merger above, these transactions are treated as the sale of the Target's assets to the Sub, followed by the Target's liquidation and the distribution of the stock received to the Target's stockholders. See note 23, supra. The Sub's use of the Acquirer's stock to effect the nontaxable acquisition of the Target is authorized by Section 368(a)(2)(D) of the Code.

in the merger. The Target's assets retain their Carryover Basis in a nontaxable stock purchase,[31] just as they do in a taxable stock purchase. The Carryover Basis is likewise unaffected by a reverse merger of the Acquirer into the Target.[32] Finally, the Carryover Basis survives the reverse triangular merger of the Sub into the Target even though the Target's stockholders may receive either the Target's post-merger shares[33] or the Acquirer's shares[34] as their consideration in the merger.

To summarize the tax effects of an acquisition, if the Acquirer does not intend to use stock as payment for the Target's business, the transaction is taxable to the seller, regardless of whether the seller is the Target or the Target's stockholders. In a taxable transaction, the Acquirer realizes lower taxable income in future tax years by choosing an acquisition method which allows it to take a Cost Basis in the Target's assets. These methods include the asset purchase, the merger and the triangular merger. If the Acquirer is willing to use its stock to effect a nontaxable acquisition or desires, for other reasons, to acquire the Target's stock in a taxable transaction which is either a stock purchase, a reverse merger or a reverse triangular merger, the Acquirer is limited to a Carryover Basis in the Target's assets. In doing so, the Acquirer must consider the loss of the opportunity for lower taxable income in future years as a consequence of its choice.

GAAP EFFECTS

The Acquirer accounts for its acquisition of the Target's business under generally accepted accounting principles (GAAP) in one of two ways, either as a pooling of interests or as a purchase.[35] The Acquirer uses the pooling of interests method to describe a transaction in which the Acquirer and Target combine their ownership interests through a transfer of at least 90% of the Target's voting common stock or of all of the Target's net assets to the Acquirer in exchange for the Acquirer's voting common stock.[36] Under this method, the assets and liabilities of the Acquirer and the Target are simply combined at the amounts recorded on their respective books, thus resulting in the Acquirer's obtaining a Carryover Basis in the Target's

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[31] N. W. Pugh Co., Inc. v. Helvering, 70 F.2d 776 (D.C. Cir. 1934), cert. denied, 293 U.S. 575. The Acquirer's basis in the Target's stock is the basis of that stock in the hands of the Target's stockholders. I.R.C. § 362(b).

[32] See note 25, supra. See also Aetna Casualty and Surety Company v. United States, 403 F. Supp. 498, 508 (U.S.D.C. Conn. 1975)(dicta).

[33] The receipt by the Target's stockholders of post-merger stock is treated like a nontaxable reverse merger. See note 32, supra.

[34] When the Target's stockholders receive the Acquirer's voting stock in a reverse triangular merger, the acquisition is nontaxable. I.R.C. § 368(a)(2)(E); I.R.C. § 354(a)(1). The Target's assets retain their Carryover Basis as described in note 31, supra, in this deemed stock purchase by the Acquirer of the Target's shares. See Rev. Rul. 67-448, 1967-2 C.B. 144.

[35] It is assumed for purposes of this article that, as a result of the acquisition, the Acquirer will exercise control over the Target's business. If the Acquirer is unable to exercise control over the Target's business after the acquisition, the Acquirer's investment in the Target's business will, depending on the circumstances, be accounted for under (i) the cost method described in Statement No. 4 issued by the Accounting Principles Board in 1970, (ii) the cost or market method described in Statement of Financial Accounting Standards No. 12 issued by the Financial Accounting Standards Board in 1971, or (iii) the equity method described in Opinion No. 13 issued by the Accounting Principles Board in 1971. Acquisitions in which the Acquirer fails to exercise control over the Target's business after the acquisition are generically referred to as other acquisitions, while acquisitions in which the acquirer exercises control over the Target's business after the acquisition are referred to as business combinations. For a comprehensive discussion of the applicable accounting issues arising in acquisitions, see Fiflis, Accounting for Mergers, Acquisitions and Investments, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent Company-Only and Consolidated Statements, 37 The Business Lawyer 89 (1981).

[36] Accounting Principles Board Opinion No. 16, ¶¶ 42, 47b.

assets.[37] The Acquirer and the Target also combine incomes for the entire fiscal period in which the transaction occurs, and the reported income of both for prior periods is combined and restated as income of the combined corporation.[38] The Acquirer's net income in both the current fiscal year and in prior years is affected by a transaction accounted for as a pooling of interests, with the precise impact depending upon whether the Target has realized income or loss during the affected periods. Obviously, the Acquirer's earnings per share (EPS) are also affected, but the effect of the transaction on EPS is not only a function of the Target's net income or loss but also of the number of shares of the Acquirer's stock which were issued to consummate the transaction.[39] There are specific conditions relating to the combining companies, the combining of ownership interests and the absence of planned transactions which must all be met before the transaction is accounted for as a pooling of interests.[40] These conditions include, but are not limited to, a prohibition of poolings by subsidiaries (except by the Acquirer's Sub who transfers the Acquirer's voting common stock in exchange for the Target's voting common stock),[41] a 10% limitation on intercorporate

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[37] Id. at ¶ 12.

[38] Id.

[39] For example, the Acquirer's EPS can decline even though the Target had significant net income during the affected periods if the Acquirer issues such a large number of shares of its voting stock to consummate the transaction that the positive impact of the Target's net income is overcome by the dilutive effect of the additional outstanding shares.

[40] The specific conditions are classified as relating to combining companies, the combining of interests and the absence of planned transactions and appear as follows:

A. Combining Companies

1. Neither company has been a subsidiary of any other corporation during the two-year period preceding the date on which the plan of combination is initiated.

2. Neither company owns more than 10% of the outstanding voting stock of the other company.

B. Combining of Interests

1. The combination must be completed in one transaction or in accordance with a plan within one year after the plan is initiated.

2. The stock offered by one company must have rights identical to those of the majority of its outstanding voting common stock and be offered in exchange for substantially all of the voting common stock of the other company.

3. Neither company may change its equity interest in contemplation of the combination within two years of the initiation of the plan of combination.

4. Neither company has acquired shares of its voting common stock for purposes of business combinations.

5. Each individual common stockholder maintains the same ownership interest in a combining company relative to the other stockholders of that company as a result of the combination.

6. The voting interests in the combined corporation must be exercisable by the stockholders without restriction.

7. The plan of combination must provide that the combination is to be resolved at the date of consummation without future additional issuances of shares or other consideration either to the former stockholders of the combined corporation or to escrow agents.

C. Absence of planned transactions

1. There can be no agreement by the combined corporation to retire or reacquire shares issued to effect the combination.

2. No arrangements may be made by the combined corporation to benefit former stockholders of any combining corporation.

3. The combined corporation does not intend to dispose of a significant part of the assets of the combining companies within two years of the combination except in the ordinary course or to eliminate duplications. Accounting Principles Board Opinion No. 16. ¶ 46-48.

[41] Id. at ¶ 46a.

investments between the Acquirer and the Target,[42] a one-year completion deadline from the initiation date of the acquisition plan,[43] and the prohibition of any agreement to issue additional shares based on some contingency.[44] Any transaction which meets all of the requirements must be accounted for as a pooling of interests,[45] but any transaction which does not must be accounted for as a purchase.[46]

The purchase method of accounting for acquisitions requires that assets or stock acquired from the Target be recorded on the Acquirer's books at their cost to the Acquirer.[47] The Acquirer, in an asset acquisition, allocates the purchase price among the Target's assets and liabilities on the basis of their fair values (which reflect the tax effects of the transaction) at the date of the acquisition.[48] Because the Target becomes a subsidiary of the Acquirer in a stock acquisition, the Acquirer records the stock purchase price as an investment in subsidiary, which has no immediate effect on the carrying value of the Target's assets and liabilities. However, when the Acquirer prepares consolidated financial statements, the account entitled investment in subsidiary is eliminated, and the purchase price is allocated among the Target's assets and liabilities in the same manner as in an asset acquisition.[49] In either an asset or a stock acquisition, any excess of the purchase price over the fair value of the assets and liabilities or stock acquired appears on the Acquirer's financial statements as goodwill, either immediately in an asset acquisition or upon consolidation in a stock acquisition.[50] Any goodwill recorded in the acquisition is amortized over a period not to exceed forty years.[51] Under the purchase method, the Acquirer receives no benefit from any net income that the Target earned prior to the acquisition date. In addition, the Acquirer should expect to experience reductions in the future net income from the Target's business due to increased expenses arising from the depreciation of assets now shown at their generally higher fair market values on the Acquirer's books as well as from the amortization of goodwill.

Based upon this discussion of the two methods of accounting for acquisitions, one is now prepared to examine the six alternatives available for effecting acquisitions in order to determine the accounting treatment appropriate to each. An Acquirer who does not issue its voting common stock in conjunction with an asset purchase, merger, triangular merger, stock purchase or reverse triangular merger, or who does not meet all of the pooling conditions, must account for the transaction as a purchase. Similarly, the Target in a reverse merger who does not issue post-merger shares of its voting common stock or who, as the surviving corporation in the reverse merger, does not meet all of the pooling conditions, accounts for the reverse merger as a purchase. An Acquirer who issues its voting common stock to consummate an asset purchase, merger, triangular merger, stock purchase or reverse triangular merger and who meets all of the

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[42] Id. at ¶ 46b.

[43] Id. at ¶ 47a.

[44] Id. at ¶ 47g.

[45] Id. at ¶ 44.

[46] Id.

[47] Id. at ¶ 67.

[48] Id. at ¶ 87.

[49] Accounting Research Bulletin No. 51 discusses the rationale for the preparation of consolidated financial statements.

[50] Accounting Principles Board Opinion No. 16, ¶ 68.

[51] Accounting Principles Board Opinion No. 17, ¶ 9.

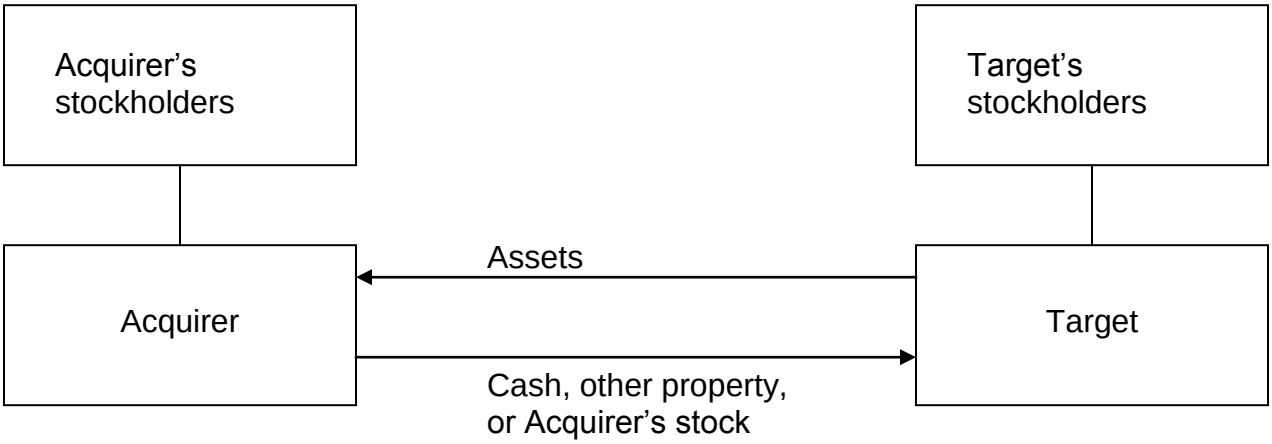
pooling conditions accounts for the transaction as a pooling of interests. Likewise, the Target's issuance of its post-merger shares in exchange for the shares of the Acquirer's stockholders, together with the Target's fulfillment of all pooling conditions, requires the Target, as the surviving corporation in a reverse merger, to account for the transaction as a pooling of interests.

SUMMARY

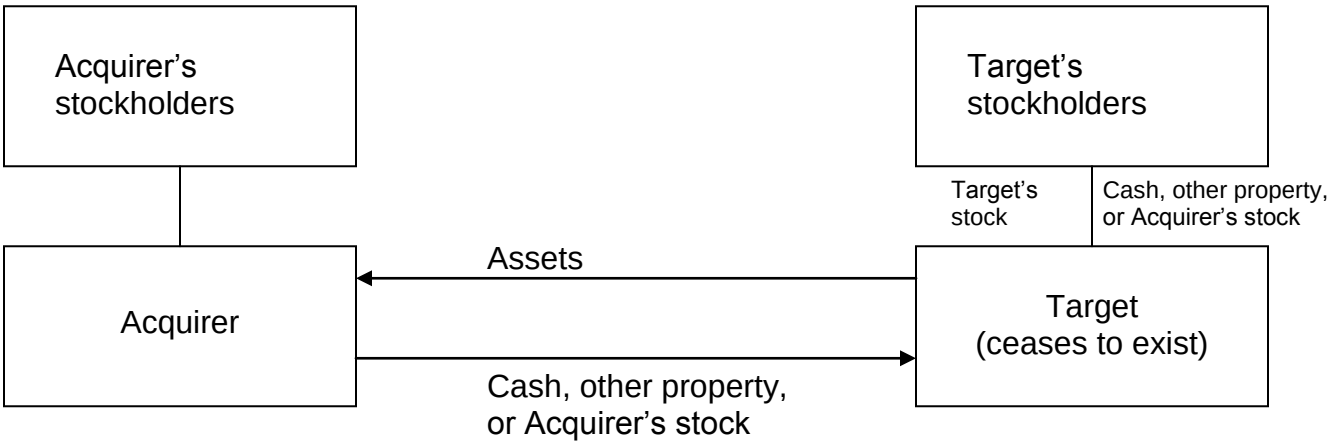
The method one chooses as the vehicle for effecting an acquisition is a function of the desired legal, tax and accounting effects of the acquisition. Every Acquirer wishes to consummate an acquisition which allows the Acquirer to (i) receive unencumbered assets, (ii) avoid incurring additional expense in obtaining consents to assignment while insuring that all contractual rights necessary to the ongoing business have been received, (iii) avoid loss after the acquisition from contingent or undisclosed liabilities associated with the Target's business, (iv) minimize taxable income in its tax return by obtaining the greatest possible deductions for the depreciation and amortization of acquired assets, and (v) maximize net income and EPS as reflected in its financial statements by avoiding greater deductions for depreciation of acquired assets and the amortization of goodwill. Unfortunately, many of these objectives are mutually exclusive. The best method to acquire any company is the one which offers an opportunity to achieve as many of the above objectives as possible while insuring that the Acquirer's paramount objective, that of acquiring the Target's business, is in fact accomplished.

David W. Hammer

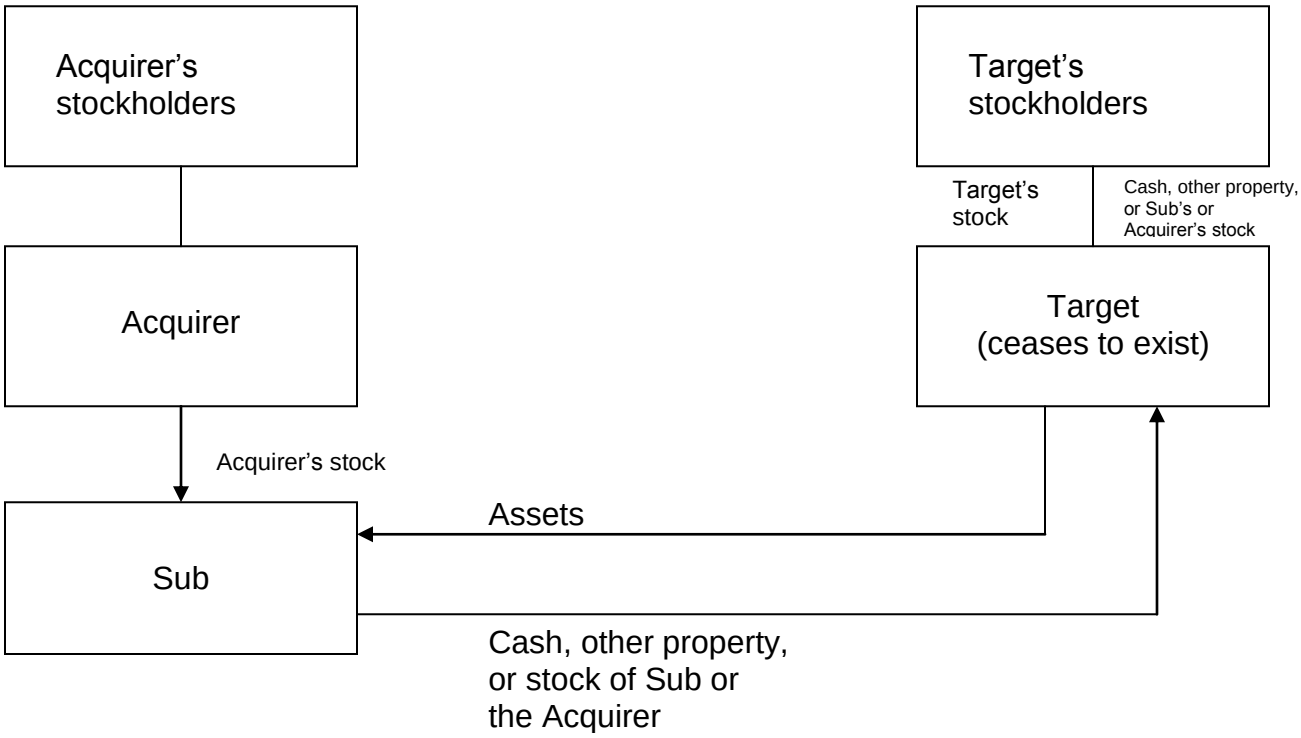
ASSET PURCHASE



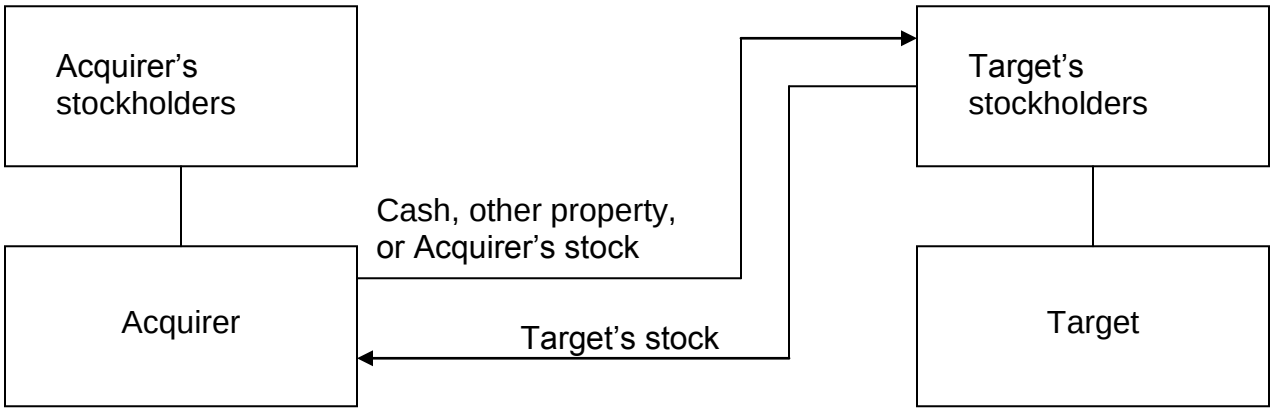
MERGER


Acquirer's stockholders
Target's stockholders
Target's stock
Cash, other property, or Acquirer's stock
Assets
Acquirer
Target (ceases to exist)
Cash, other property, or Acquirer's stock

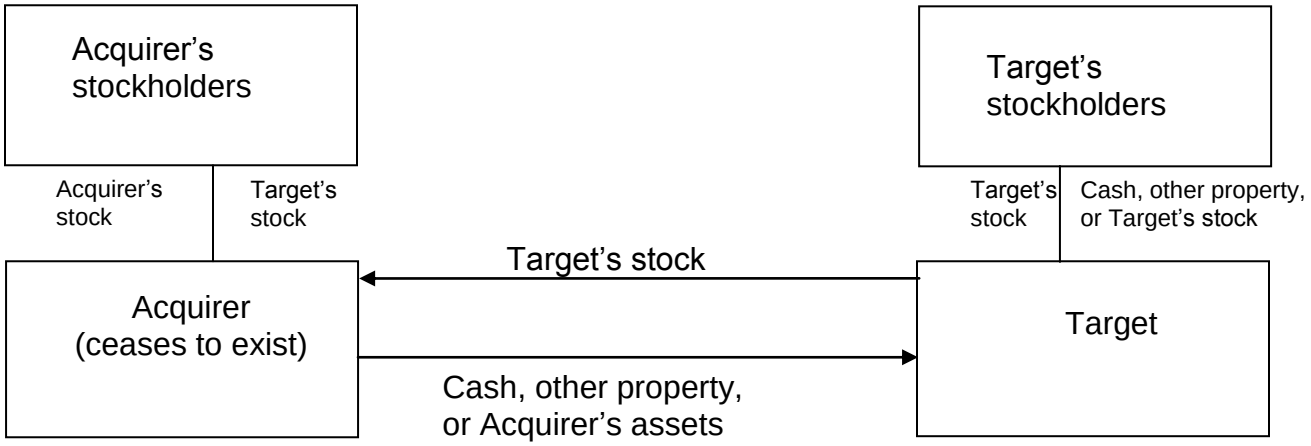
TRIANGULAR MERGER



STOCK PURCHASE



REVERSE MERGER



REVERSE TRIANGULAR MERGER