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TAX IMPLICATIONS OF A MERGER: A CASE STUDY

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ABSTRACT

This paper considers possible tax implications of the merger between a wholly-owned subsidiary of Domestic Co, Inc. and International Co, Ltd, which took place on November 10, 2008. Even though the merger is structured in a way that it will most likely be respected as a tax-free reorganization under section 368(a), several important representations and warranties are not included in the merger agreement. Specifically, this particular merger agreement does not have a tax warranty requiring the Target Company to file all material tax returns and does not have a warranty requiring the parties to the reorganization to refrain from any actions that would prevent the merger from qualifying as reorganization within the meaning of section 368(a) of the Internal Revenue Code.

JEL: K30; K34

KEYWORDS: Tax-Free Reorganization, Legal Opinion, Covenants, Representations, Warranties, International Mergers

INTRODUCTION

Over the last decade, there has been a significant increase in the numbers of cross-border mergers and acquisitions between American, European and Asia companies (Kasipillai, 2004). A merger is a combination of two or more companies, where a new business entity is formed as the result (Kasipillai, 2004). During mergers and acquisitions, numerous tax considerations will arise that will have financial implications for the new entity and its shareholders (Kasipillai, 2004).

In order to comprehend dynamics of merger activities, it is useful to identify the past and current trends of mergers and acquisitions in the United States while investigating such consolidation trends (Yaylacicegi, 2005). American industrial history has been marked by many different merger waves: one in 1890s, one in 1920s, one in 1960s, another in 1980s and 1990s. (Yaylacicegi, 2005).

However, in today’s business environment, entrepreneurs are no longer taking the time to examine merger and consolidation transactions in a way that they have in the past (Hurtt, 2000). Today it is almost malpractice not to close the transaction in just several days (Hurtt, 2000). Yet, the volume of the deals and the risk exposure has increased dramatically over the last twenty years (Hurtt, 2000). Therefore, to increase the chances of a successful merger, company management cannot overlook the details and not take the necessary precaution steps (Hurtt, 2000).

While the tax consequences of mergers and acquisitions have been substantially analyzed in previous literature, previous studies fail to consider practical and economic consequences that stretch beyond the theoretical tax-free treatment under IRC section 368. This study elaborates on the practical consequences of a tax-free merger to all of the parties involved and considers potential issues that need to be addressed in the merger agreement (Yaylacicegi, 2005).

The remainder of this paper is organized as follows: The next section examines the related literature and tax law as it relates to the tax-free reorganizations. The next section introduces the Case of an international merger. Section that follows examines the recommendations for improving the merger. The final section concludes.

LITERATURE REVIEW

When companies merge, their management focuses on the deal's positive aspects and contributes significant efforts to complete their due diligence as soon as possible and to ensure that the merger is successful (Sinkin, 2007). However, numerous issues arise during merger negotiations, where some mergers and acquisitions fail even before they reach a formal merger agreement stage, while others will have problems after the agreement is completed (Hurtt, 2000).

In today's business environment, company's management expects their due diligence process to be completed within just days as opposed to months (Hurtt, 2000). *Fortune* magazine (November 8, 1999) reports that in 1995, the typical merger and acquisition transaction took between six to nine months to complete (Hurtt, 2000). Compare to some of the largest deals in 1999, where Proctor and Gample used a time frame of 60 days to acquire pet food maker Iams for $2.3 billion (Hurtt, 2000). Furthermore, the volume of the deals and the risk exposure has increased dramatically over the last twenty years (Hurtt, 2000). For example, merger and acquisition activity in the United States reached a total volume of $880 billion for the first two quarters of 1999 and was expected to match or exceed the 1998's record volume of $1.6 trillion (Hurtt, 2000). Since mergers and acquisitions are now completed more quickly and at record-breaking volumes, company's management cannot overlook the details surrounding the deal and must take the necessary precaution steps to increase the chances of a successful transaction (Hurtt, 2000).
During mergers and acquisitions, numerous tax considerations will arise that will have financial implications for the new entity and its shareholders (Kasipillai, 2004). Oftentimes, it is beneficial to structure such a transaction as a tax-free reorganization under Internal Revenue Code Section 368 (Schwartzman, 2005). In IRC section 368(a)(1)(A), the term reorganization includes merger or consolidation (Schwartzman, 2005). Any type of consideration can be used in such transactions (Schwartzman, 2005). Even cash can be exchanged in return for the stock of the target company, as long as continuity of business enterprise and continuity of interest are satisfied (Schwartzman, 2005). In January 2005, IRS issued proposed regulations, which later became final, allowing tax-free treatment for cross-border mergers organized under foreign law, providing a tremendous amount of flexibility in restructuring foreign and domestic businesses (Schwartzman, 2005).

In order to qualify as a tax-free reorganization under IRC section 368, a merger transaction must meet certain requirements. Specifically, the transaction must be structured as prescribed under one of the types in IRC section 368, there must be a plan of reorganization and continuity of business enterprise, continuity of interest and solid business purpose must also be present. If the transaction is structured properly, no gain or loss will be recognized by the acquiring and target companies. A reverse subsidiary or a reverse triangular merger is a process by which an acquiring company merges its subsidiary into the target company. Both the acquiring company and the target company remain in existence after the merger (Figure 1 and 2).

Figure 1: Reverse Subsidiary Merger-Before

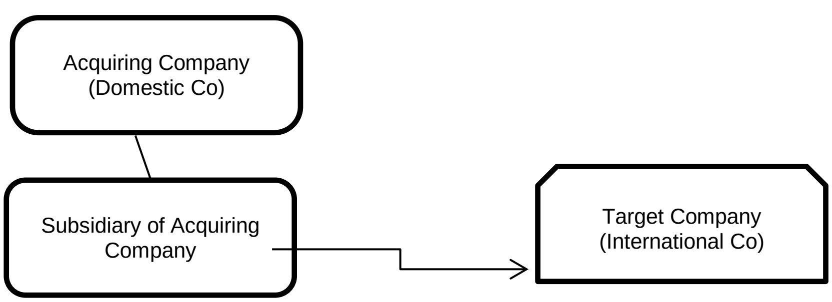
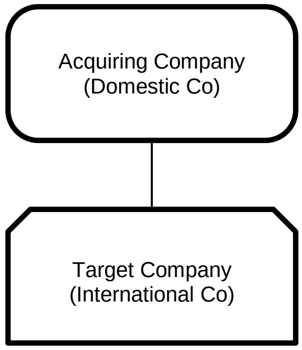


Figure 2: Reverse Subsidiary Merger After



THE CASE OF AN INTERNATIONAL MERGER

In November of 2008, Domestic Co, Inc. (Parent Corporation) and International Co, Ltd. (Target) entered into an Agreement and Plan of Merger, according to which Subsidiary Co, Ltd., a wholly-owned subsidiary of Domestic Co organized in a foreign country, was to merge with and into International Co, with International Co continuing after the merger as the surviving company and a wholly-owned subsidiary of Domestic Co. Prior to the merger, as of September 30, 2008, it was estimated that the proposed combined company will have pro forma revenues of $55.6 million and gross profit of $39.1 million. However, even though a definite merger agreement was signed and the deal was to close in the first quarter of 2009, the transaction fell through due to another company starting negotiations to purchase Domestic Co and issues needed to be addressed before the Federal Trade Commission due to possible violations of the antitrust laws. Presently, the dispute between Domestic Co and International Co has not been resolved.

Domestic Co, Inc. is an innovative medical device company based out of California focused on the development of minimally invasive technologies for tissue and tumor ablation. Domestic Co had initially concentrated on the development of freezing technologies for the treatment of prostate cancer and believes that its proprietary technologies have broad applications across a number of markets, including the ablation of tumors in the kidney, lung and liver.

Subsidiary Co, Ltd. is a newly formed Israeli corporation and wholly-owned subsidiary of Domestic Co organized for the purpose of completing the proposed merger. It does not conduct any business, has no assets or liabilities of any kind, other than those incidental to its formation and the merger.

International Co, Ltd. is an Israeli corporation and is leading a new era of minimally invasive freezing solutions that enhance patient's quality of life. Since its formation, International Co dedicated extensive research toward increasing the ease of the use of freezing technologies in order for physicians to provide patients with rapid recovery and high quality of life.

In the merger, Subsidiary Co will merger into International Co and terminate. After the merger, International Co will continue as a surviving company and will be a wholly-owned subsidiary of Domestic Co. According to the merger agreement, each outstanding ordinary share of International Co will be converted into common shares of the parent company, Domestic Co, in accordance with the pre-determined exchange ratio. The consideration for this transaction will consist of strictly stock, where no fractional shares and no cash in lieu of those fractional shares will be issued. Following the merger, International Co shareholders will no longer have any interest in International Co, but will have an equity stake in Domestic Co.

Based on the facts described above, this merger transaction qualifies as a tax-free reorganization under section 368(a), specifically, as a reverse subsidiary merger. Immediately after the merger, the existing Domestic Co stockholders are expected to own approximately 52% of the outstanding shares of Domestic Co common stock and former shareholders of International Co are expected to own approximately 48% of Endocare common stock. Thus, the requirements of continuity of business enterprise and continuity of interest seem to be satisfied. According to the prospectus, Domestic Co and International Co were proposing to merge because they believe that the merger will permit a consolidation of resources that will result in greater penetration of the marketplace, will create efficiency opportunities, improve product platform and result in a stronger international position. All of these reasons will probably help establish a valid business purpose for the merger transaction. Furthermore, on the face of the documents filed with the SEC, there is no evidence that the transaction was part of a larger plan that if taken in its entirety would be a taxable transaction. Thus, without any other facts, the step transaction doctrine does not apply. According to the merger agreement, both shareholders of Domestic Co and shareholders of International Co approved the merger transaction.

As the result of this merger transaction, International Co (Target) shareholders will have no gain or loss recognized on the exchange of their stock for the stock in Domestic Co. The Target's shareholders' basis in the new stock will equal to the basis of the old stock that they previously owned. Similarly, Target corporation itself will have no gain or loss recognized on the transfer of its assets to Domestic Co. Likewise, Domestic Co (Parent Corporation) will have no gain or loss recognized on the transfer of its own stock in exchange for Target's stock. Finally, the basis in the stock received from Target shareholders will equal to the Target shareholder's basis in the old shares.

The form selected for this transaction seems to be particularly appropriate. Both the Parent and the Target companies are engaged in almost identical lines of businesses, doing similar research and establishing similar goals. The integration of the Target's business with the business of the Parent Corporation should be smooth and natural. Finally, since the Parent Corporation is interested in the direct control of the Target, the reverse subsidiary merger seems to be the best form for this transaction.

RECOMMENDATIONS FOR IMPROVING THE MERGER

As one of the exhibits to the form S-4 filed with the SEC, there was a legal opinion provided by tax counsel to Domestic Co in connection with the proposed merger transaction. It was a short term opinion establishing that the law firm reviewed the merger agreement and other documents necessary and appropriate for the purposes of this transaction. Furthermore, the opinion stated that there were four basic assumptions made by tax counsel.

Namely, it was assumed that a) the merger transaction will take place exactly as described above, b) representation and warranties made in the merger agreement are true and accurate, c) officer's certificates provided by Domestic Co to the law firm are also true and accurate, and d) any representations made in the officer's certificates are also correct. Therefore, if any of the representations or warranties in the merger agreement were inaccurate or incomplete, the opinion given to Domestic Co could not be relied upon.

Most importantly, the opinion provided that 1) the merger described above will constitute a reorganization within the meaning of section 368(a) of the Code, 2) each of Domestic, Subsidiary, and International will be "a party to the reorganization" within the meaning of section 368(b), and 3) statements made in the merger agreement under section "Material United States Federal Income Tax Consequences of the Merger" constituted their opinion as tax counsel to Domestic Co.
Moreover, the opinion provided that it was only a best judgment of how Internal Revenue Service or a court would conclude if presented with the facts described above. The opinion further stated that no

assurance can be given that a position taken in reliance on the given advice will not be challenged by the IRS or rejected by a court. The opinion stated that it has a limited scope and applies only to the United States tax consequences of this particular merger. Finally, the opinion provided that the law firm had no obligation to update this opinion after it has been issued, even if circumstances affecting the conclusions made in this opinion were to change.

After reviewing the prospectus and the legal opinion, it appears that the amount of disclosure and disclaimers included in the public filing is more than sufficient. The prospectus goes through a very detailed list of common questions that the shareholders could have about the transaction and provides detailed answers. Furthermore, the prospectus goes through a list of reasons for the merger transaction, conditions to completion of the merger, and all of the possible risk factors that could relate to the prospective merger transaction. Among some of the risks identified is a warning that 1) the alliance between Domestic Co and International Co might not prove to be profitable, 2) Domestic might be required to make tax payments that exceed the settlement estimates determined prior to the merger, 3) market price of Domestic's common stock is highly volatile (see table above), 4) issuance of common stock in the merger transaction will trigger an ownership change that will negatively impact Domestic's ability to utilize net operating loss and capital loss deferred tax assets in the future, 5) International has a limited operating history with significant losses, 6) success of Domestic's business is dependent upon the industries acceptance of the new freezing technologies, 7) business success depends on the necessity to obtain regulatory clearances and approvals for the new freezing technologies, and 8) there are risks associated with doing business internationally. The disclaimers described in the prospectus are complemented by those included in the legal opinion and are sufficient to disclose all material risks associated with the merger.

Such tax matters section of the merger agreement constitutes an actual legal opinion given by tax counsel. It provides general tax advise that is neutral to both the buyer and the seller and which alone would probably be insufficient to provide adequate advice to a shareholder in a situation covered by any of the special rules, such as dealers in securities, non-U.S. Holders, banks, mutual funds, insurance companies, financial services entities, tax-exempt entities, and holders who do not hold their shares as capital assets, who acquired their shares through stock option or stock purchase programs or otherwise as compensation, who are subject to alternative minimum tax, or who hold their shares as part of a hedge, straddle or other risk reduction transaction and persons who hold, directly, constructively or by attribution, 5% or more of either the total voting power or total value of the capital stock of Domestic Co immediately after the Merger, or 10% or more of the total voting power of the capital stock of Domestic Co at any time.
Moreover, tax matters section also provides a definition of the U.S. Holder, states that the merger will be a tax-free reorganization covered under section 368(a), and that no gain or loss will be recognized for the United States federal income tax purposes by Domestic Co, Subsidiary, or International Co as the result of this merger. For any of the special rule situations described above, the section states that shareholders should consult their own tax advisors in light of their specific circumstances and the consequences under applicable state, local, and foreign tax laws. Finally, this section also discussed material Israeli tax consequences of the merger transaction, specifying that it will be a taxable transaction under Israeli tax laws unless special exemptions applied or a double-taxation prevention treaty provided otherwise.
The warranties section of the merger agreement contains representations by both Domestic Co and International Co with respect to the merger transaction, including: 1) warranties included are true and correct in all material respects, 2) parties have performed in all material respects the conditions required by the merger agreement, 3) parties had received an opinion from their tax counsel regarding the merger transaction stating that it qualifies under section 368(a) as a tax-free transaction and that no material gain or loss will be recognized by Domestic or International as the result of the transaction, 4) no governmental authority is investigating the merger agreement or its other ancillary agreements, and 5) no government authority had enacted any law that would materially restrain, condition, or make illegal the consummation of this merger transaction.

Warranties section of the merger agreement also specifies that it contains customary representations and warranties of the parties, including tax matters. However, specific tax matters discussed are those requiring the Israeli tax rulings and other Israeli approvals prior to closing. Under this section of the merger agreement, International Co warrants that it will cause its Israeli counsel to prepare, file, and use best efforts to obtain tax rulings that provide full exemption to Domestic Co and International Co from withholding requirements that result from a deferral of Israeli income taxes. No other tax warranties were included in this section covering United States tax consequences, such as a requirement of timely filing of tax returns and a prohibition against actions that could materially affect this merger transaction and cause it to become a taxable event for the United States tax consequences. Therefore, it appears necessary to add both of these warranties. Since International Co is in the business of selling products internationally, it could have some of its income sourced to the United States and be required to file income tax returns or sale and use tax returns that might have been overlooked in the past, particularly since it will now be a wholly-owned subsidiary of the United States parent and its prior tax returns are now more likely to be audited.

For the warranty covering all material tax returns filed by International Co, the following or similar language should be included: “Except as has not had and would not reasonably be expected to have, either individually or in the aggregate, International Co. and its Subsidiaries (a) have duly and timely filed, or have caused to be duly and timely filed, all Tax Returns, including income and sale and use tax returns, required to be filed by any of them (taking into account any extension of time within which to file) and all such Tax Returns are complete and accurate in all respects and were prepared in compliance with all applicable Laws; (b) have paid all Taxes that are required to be paid (whether or not shown on any Tax Return) or that International Co or any of its Subsidiaries are obligated to deduct or withhold from amounts owing to any employee, creditor or other third party, except with respect to matters contested in good faith through appropriate proceedings or for which adequate reserves have been established on the International Co Current Balance Sheet; and (c) have not waived any statute of limitations with respect to United States federal income Taxes or agreed to any extension of time with respect to a United States federal income Tax assessment or deficiency.

Except as has not had and would not reasonably be expected to have, either individually or in the aggregate, there are no audits, examinations, investigations, deficiencies, claims or other proceedings in respect of Taxes or Tax matters pending or, to the Knowledge of International Co, threatened in writing, except with respect to matters contested in good faith through appropriate proceedings. Except as has not had and would not reasonably be expected to have, either individually or in the aggregate, International Co and its Subsidiaries had not received notice in writing of any claim made by any Governmental Entity in a jurisdiction where International Co does not file Tax Returns that International is or may be subject to taxation by that jurisdiction. Except as has not had and would not reasonably be expected to have, either individually or in the aggregate, International Co has not participated, or is currently participating, in a “listed transaction” as defined in Treasury Regulation Section 1.6011-4(b)(2). All copies of United States federal and state income or franchise Tax Returns, examination reports, and statements of deficiencies assessed against or agreed to by International that International has made available to Domestic are true and complete copies. International has not been a member of a group filing Tax Returns on a consolidated, combined, unitary or similar basis (other than a consolidated group of which International was the common parent). Except as has not had and would not reasonably be expected to have, either individually or in the aggregate, International Co does not have any liability for Taxes of any Person (other than International Co) under Treasury Regulation Section 1.1502-6 (or any comparable provision of local, state or foreign Law), as a transferee or successor, by Contract, or otherwise or is a party to, bound by or has any liability under any Tax sharing, allocation or indemnification agreement or arrangement.”

For the warranty covering prohibition against actions that might cause material adverse effects to the merger transaction, the following or similar language should be included: "As of the date of this Agreement, International Co, Domestic Co or Subsidiary have not taken or agreed to take any action, nor do International, Domestic or Subsidiary Companies have any Knowledge of any fact or circumstance, that would prevent this Merger from qualifying as a reorganization within the meaning of Section 368(a) of the Code."

Moreover, according to the merger agreement, the representation and warranties of International Co survive for the period beginning on the closing date, which was expected to take place in the first quarter of 2009, through the date of Domestic Company's required filing with the SEC of its Annual Report on Form 10-K for the fiscal year ended December 31, 2009. Such survival period would last, at most, for about one year or a year and three months. It would provide Domestic Co a greater level of protection if International Company's warranties were to survive for at least three years, for a period of the statute of limitations. If any claims were to arise against International Co for breach of any representations or warranties included in the merger agreement, Domestic Co would have a longer time period to bring those actions and recover damages.

Finally, representations and warranties of Domestic Co made in the merger agreement do not survive the closing at all. Again, it would provide International Co a much greater level of protection if Domestic Company's warranties were to survive for at least the period of the statute of limitations. Some of the more important warranties for International Co could be the anti-takeover protections, capitalization, and absence of certain changes and events, which were all warranted by Domestic Co. International Co would only greatly benefit if those protections were to extend beyond the closing date.

Under the terms of the merger agreement, Domestic Co will set up an escrow account to satisfy any possible indemnification obligations. Domestic Co will deposit a number of shares of its common stock equal to 7.5% of the total number of shares of its common stock comprising the aggregate merger consideration rounded to the nearest whole share, which would amount to approximately $1,013,795. Total number of shares to be transferred as consideration, 11,857,248, times 7.5% is 889,294 shares to be deposited in the escrow account; 889,294 times $1.14 price per share (as of November of 2008) of the Domestic Co stock is $1,013,795 to be deposited in the escrow account.

This amount could be used to cover any indemnification claims, including any tax related claims. The merger agreement provides that Domestic Co will be indemnified and held harmless solely out of indemnity escrow against any losses or other liability to the extent arising of any and all taxes of International Co with respect to (x) taxable periods ending on or before the Closing Date or (y) any taxable period that commences before and ends after the Closing Date to the extent attributable to the period prior to Closing as determined pursuant to the Merger Agreement, and (z) reasonable costs and expenses incurred by the Surviving Company in connection with compliance matters relating to taxes for which Domestic Co is entitled to indemnification under the Merger Agreement, including costs and expenses relating to disputes with taxing authorities. However, such escrow account could be insufficient to cover all possible claims including tax liabilities. It would provide Domestic Co a greater level of protection if indemnification provision was not restricted solely to the deposited escrow funds or the amount deposited was increased.

CONCLUDING COMMENTS

In today's business environment, entrepreneurs are no longer taking the time to examine merger and consolidation transactions in a way that they have in the past. Even though mergers have significant tax implications to all parties involved, company management often chooses speed and efficiency over detailed examination of the contractual agreements involved in the merger. Yet, the volume of the deals and the risk exposure involved has increased dramatically over the last twenty years. As such, to increase the chances of a successful merger, managers must examine specific sections of the merger agreement in great detail.

This paper examines practical tax implications of a tax-free merger under IRC section 368 between domestic and international companies. Specifically, it examines legal opinion and tax matters section of a particular merger agreement to expose its limitations and shortcomings.

Even though Domestic Co and International Co merger is structured in a way that it will most likely be respected as a tax-free reorganization under section 368(a), several important representations and warranties are not included in the merger agreement, which could potentially create future tax liability for the parent company and, therefore, adversely affecting its shareholders. Specifically, this particular merger agreement does not have a tax warranty requiring the International Company to file all material tax returns and does not have a warranty requiring the parties to the reorganization to refrain from any actions that would prevent the merger from qualifying as reorganization within the meaning of section 368(a) of the Internal Revenue Code. Furthermore, the amounts deposited in the escrow account are most likely insufficient to cover all possible claims including tax liabilities. It would provide Domestic Co a greater level of protection if indemnification provision was not restricted solely to the deposited escrow funds or the amount deposited was increased.

The analysis of this paper is based upon a number of assumptions. Namely, it was assumed that a) the merger transaction will take place exactly as described above, b) representation and warranties made in the merger agreement are true and accurate, c) officer's certificates provided by Domestic Co to the law firm are also true and accurate, and d) any representations made in the officer's certificates are also correct. Therefore, if any of the representations or warranties in the merger agreement were inaccurate or incomplete, the analysis of this paper would also have to be reexamined. These factors remain a creative area for future research.

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Internal Revenue Code Section 368(a)(1).
Appropriate public filings with the SEC, including Form S-4.

Disclaimer: This case was prepared by Dr. Valeriya Avdeev from William Paterson University and is intended to be used as a basis for class discussion. Even though the analysis is based on real data gathered from a merger of a domestic company with an international company, the names of the companies used in the paper are fictional. The views presented here are those of the case author and do

not necessarily reflect the views of The Institute for Business and Finance Research. Author's views are based on her own professional judgment.

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