Fair Market Value — Real World Examples

This is the second part of our discussion of fair market value. In the last issue, we covered the importance of fair market value and its relationship to basis allocation and how CCH derives its numbers. Here we look at actual cases that illustrate some of the difficulties we encounter when determining fair market value.

No tax opinion

One of the most frustrating aspects of reporting corporate actions is that, unless the company provides a complete opinion on taxability, we cannot make assumptions regarding tax consequences that are not addressed. Even if the issue seems fairly clear on its face, we cannot render our own opinion because we do not have access to all the information that might bear on the issue. Moreover, if the company offers a cursory or contradictory tax opinion that, for instance, says a transaction is taxable but does not provide guidance on how to calculate gain or loss, we cannot necessarily assume that a fair market value is called for or which date is to be used for determining such value.

Foreign companies that do not have a significant presence in the United States often do not provide an opinion on U.S. tax consequences, but even large companies sometimes fail to do so. Thus, when Sumitomo Bank Ltd. and Sakura Bank Ltd. merged to form Sumitomo Mitsui Bank Corp., ADR holders were left to make their own determination regarding taxability. See ADR/Global entries dated 4-1-2001. Transactions involving Brazilian companies, such as the former Telebras companies, likewise often fail to provide opinions on U.S. taxability.

In another transaction, Compas Group Plc merged with Granada Group Plc to form a new company. See ADR/Global entries dated 7-5-2000. Although the company provided a tax opinion, it was impossible to determine whether the transaction was more likely to be taxable or nontaxable. Moreover, if the exchange of shares was ultimately determined to be taxable, the opinion did not explain whether any gain or loss would be taxable as a dividend or as capital gains and how any gain or loss was to be calculated. Under such circumstances, CCH cannot publish market value information.

Which date?

Another type of transaction that presents difficulties for us is a taxable exchange offer where the company does not provide clear guidance regarding the valuation date. Typically, an exchange offer expires on a given date, and if the offer is successful the company will send out the new shares up to a week afterwards. In some cases, the company will declare the offer wholly unconditional and take up shares already tendered, but it will keep the offer open for an additional period during which shareholders that did not yet tender can do so. See, e.g., ADR/Global entry for Doncasters Plc dated 7-3-2001. Shares tendered during this subsequent offering period are taken up and paid for as they come in. In such cases, the date of valuation can vary widely from one shareholder to another.

Tax opinions typically require shareholders to compare their basis in the stock tendered with the fair market value of the new stock, but they do not specify which date must be used for purposes of valuation. Unless it is clear from the prospectus which date should be used or the company publishes its own fair market value, we do not do so because we cannot determine which date to use as a basis for the calculation.

He said, she said . . .

There is more than one correct method for determining fair market value. All

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Responses to Our First Issue

With the first issue of CAP Exchange under our belt, and responses from our reader survey in, we wanted to share the results with you. The good news is that the majority of readers responding to our questionnaire found the newsletter to be favorable. In fact, 15 out of 17 readers who contacted us found the newsletter to be “very informative.”

Our favorite response was from Sue Rodaitis of Fayez, Sarofim & Co. Among other things, she told us, “I have been struggling to explain these concepts to people in my organization for years, and the newsletter does a marvelous job of doing so. I’m going to save every edition!!” Thanks, Sue.

Equally encouraging, we received many excellent suggestions for topics. For example, Philip Roy, from Wachovia Bank e-mailed us with the following:

For future topics, I would most definitely like more information on the complexities of CASH/STOCK mergers. I would like you to explain and define terms such as Holding Period, Realized gain, Recognized gains, the significance of “No Loss Recognized,” to name just a few. My unit has struggled in the past with some very complex cash/stock mergers and we’ve been limited by the trust system we process on.

These are exactly the sort of topics we intend to cover in future issues, and we are glad to know that there is strong interest. Keep an eye out for an upcoming article on recognition versus realization of gain or loss. We also intend to discuss specific corporate actions, such as the split off of AT&T Wireless Services in this issue. By the way, readers should feel free to make suggestions regarding actions they would like to see covered here.

Who Doesn’t Get It?

Do you know someone who would like to receive a copy of CAP Exchange but is not on our mailing list? Let us know. We currently send CAP Exchange to the individual listed as the subscriber, but we would be happy to send it to other members of your organization who would like to receive their own copy.

Send the names, titles and addresses of anyone else interested in receiving CAP Exchange to Karyn Blong via e-mail at blongk@cch.com or give her a call at 847/267-7049.

Horrified Britons sent NASA the disastrous results of the experiment, along with the designs of the windshields, and begged the U.S. scientists for suggestions. NASA’s response was just one sentence: “Thaw the chicken.”
that matters from the IRS perspective is that the method used be reasonable. When the company itself does not provide a fair market value, we use the average of the high and low prices of the stock for a given date. Companies are free, however, to use other methods, and in order to avoid confusion CCH will give precedence to the company’s method whenever possible. Different methods used by companies include: closing prices (see Capital Changes entries for AutoNation, Inc. dated 6-30-2000 and Hewlett-Packard Co. dated 6-2-2000, and ADR/Global entry for AstraZeneca Plc dated 11-14-2000), volume weighted averages (see Capital Changes entry for InfoCure Corp. dated 3-5-2001), or a range of dates (see Capital Changes entries for Delta Woodside Industries, Inc. (New) dated 6-30-2000 andRalston-Ralston Purina Group dated 4-1-2000).

Even so, companies are not always as precise as they might be or may not strictly adhere to the requirements of the Internal Revenue Code in determining fair market value. For example, in AutoNation prices were adjusted to the nearest 1/16th. In InfoCure the company used the first regular day of trading instead of the distribution date as required by the Code, and in Delta Woodside, where the distribution date was 6-30-2000, the company took market values from 7-3-2000 through 7-7-2000. Nevertheless, such deviations may be considered reasonable and necessary under the circumstances, in which case we simply note the methodology used, although we sometimes extend rounded numbers for the convenience of our subscribers.

**Come again?**

At other times a company may determine market values by a method that deviates markedly from reasonable practice with no readily apparent justification. In such cases, we will publish the company’s figures but we will also add our own as a point of comparison. Thus, in a stock distribution by Ceridian Corp. dated 3-30-2001, the company relied on prices for the first day of trading even though prices were available on the distribution date (the relevant date under the Code). In that case we published both the company’s market values and our own. The basis allocations resulting from the two calculations differed by more than three percentage points. A similar situation arose in a stock distribution by Massey Energy Co., see Capital Changes entry dated 12-21-2000.

**No market**

Some transactions require that a fair market value be determined for a security that is not publicly traded, or for which a value is otherwise not readily available. In such cases, CCH must either rely on the company to provide a value or must extrapolate a value based on best available information.

In a transaction by J.LX Resorts, Inc. dated 12-31-1999, the company assigned a value to the stock being spun off. Without this, the required basis allocation would not have been possible. In other cases, a transaction may involve several steps including, possibly, the intermediate distribution of stock in a company created solely for purposes of a merger. When the tax opinion calls for the fair market value of such intermediate stocks it is often necessary to determine it by reference to the ultimate stock since the intermediate stock was never actually distributed or traded. The resulting calculations can be quite convoluted. See, e.g., ADR/Global entries for Cable & Wireless Communications Plc dated 5-12-2000, Eiscom Plc dated 5-11-2001, and Teléfonos de México, S.A. de C.V. dated 2-7-2001, and Capital Changes entry for Mestek, Inc. dated 3-6-2000.

**Foreign markets**

In transactions involving foreign securities, there may not be a U.S. market for the stock being received in a spin-off or merger. In such cases, we will provide fair market values based on foreign exchanges when available. Such was the case in Euro Disney S.C.A. dated 11-15-1999 and Telecom Italia S.p.A. (New) dated 11-10-2000.

**Yes, but...**

Even when everything is correct, it may not seem right in practice. Such was the case when BCE Inc. spun off its shares of Nortel Networks Corp. The effective date of the distribution was 5-1-2000, and a week later Nortel common split 2-for-1. BCE published a market value for Nortel common based on its pre-split price, but shareholders received twice the expected number of Nortel common due to the split. We received several phone calls from subscribers asking for clarification. In conversations with counsel, we determined that the published market value was correct; however, shareholders had to adjust the value of the common to account for the split. The moral of the story? If you are not sure — call us, we might be able to explain.
Splitting Off AT&T Wireless Services

Few companies manage to capture the attention of investors like AT&T whose plans to separate its business into four independent concerns made some of this year’s biggest financial news. This summer we welcomed the first of the newly independent companies, AT&T Wireless Services, Inc.

The events leading to the birth of AT&T Wireless Services began with the creation of AT&T Wireless Group common, a tracking stock designed to reflect the separate economic performance of AT&T’s wireless group. The tracking stock debuted with an IPO in the spring of 2000. At that time, AT&T expressed its intention to dispose of its remaining interest in the wireless group through exchange offers and distributions to its shareholders.

In April 2001, AT&T offered to exchange shares of AT&T Wireless Group tracking stock for shares of AT&T common. Shareholders tendered about 372 million shares of AT&T common and got about 438 million shares of the tracking stock in a tax-free exchange.

The next move in the split-off involved a quick two-step: The exchange of AT&T Wireless Group tracking stock for new shares of AT&T Wireless Services, and distribution of most of the remaining AT&T Wireless Services shares to AT&T shareholders. The plan hinged on the receipt of a favorable IRS private letter ruling declaring it a tax-free split-off, which AT&T received at the end of May. The stage was ready for the last act, and the curtain lifted in July of 2001.

Step 1—AT&T redeemed all outstanding AT&T Wireless Group tracking stock in exchange for AT&T Wireless Services common, 1-for-1, in a mandatory nontaxable transaction.

Step 2—AT&T distributed to its shareholders most of the remaining AT&T Wireless Services common (AT&T retained about 7.3%). In this nontaxable distribution, holders of AT&T common received .3218 share AT&T Wireless Services per share held.

In Step 2, basis was allocated in proportion to the relative fair market values of AT&T common and AT&T Wireless Services common as of the split-off date (July 9). AT&T calculated the allocation based on the average of the high and low NYSE trading prices on that day, and published figures of 77.66% for AT&T common and 22.34% for .3218 share of AT&T Wireless Services common. CCH extended the figures to 77.66076% and 22.33924%.

And so AT&T Wireless Services was born. But wait, there’s more! AT&T’s Liberty Media tracking stock is set to be redeemed in early August 2001 for new Liberty Media Corp. stock in order to effect the split-off of that business.

AT&T’s business and consumer services were scheduled for their own independence days later this year, but those plans are on hold while AT&T explores its options for those services. CCH will be watching.

Did You Know . . . ?

American Depositary Receipts (ADRs) are not, technically, shares of a company. They are certificates or receipts that represent shares of the company, usually a foreign issuer whose shares are not directly traded in the United States. The shares themselves, whether ordinary, preferred or of a particular class, are held in trust by a depositary bank that holds legal title to the shares.

ADR holders only have a beneficial interest in the underlying shares. The rights and obligations of the depositary and ADR holders are governed by a trust agreement which, for example, gives the depositary the right to change the number of shares underlying each ADR, sell stock or rights received in a distribution and distribute the proceeds to ADR holders, or even terminate the deposit agreement. In addition, the depositary, not the ADR holder, usually has the right to vote at shareholder meetings unless the holder surrenders the ADR certificate and withdraws the underlying shares.

Since ADRs are separate from the underlying security, and are administered by the depositary, corporate actions that are effected in the company’s home country may not be immediately reflected in the ADRs. A distribution, reorganization or merger may take place on a given date and not be implemented as to ADR holders until days, weeks or even months later. Moreover, what ADR holders receive may differ from what regular shareholder receive due to legal restrictions or elections made by the depositary.