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### **Booyah Breakdown: Tackling Takeovers**

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*Editor's note: Welcome to "Booyah Breakdown," an explanation of certain terms and topics Jim Cramer discusses on his "Mad Money" TV show. Feel free to ask a question if you're confused about something Cramer talks about, but please keep in mind that we do not provide advice on specific stocks.*

It's no surprise that the vultures have started to swarm since hottie Carmen Electra announced her separation from her husband of three years, rocker Dave Navarro. Already, rumors have been flying about her new flings.

That's because now that she's on the singles scene again, Carmen's the hottest takeover target in Hollywood. And there clearly are good reasons to be the first on the scene of a takeover.

Just ask Jim Cramer. On his July 25 show, he discussed how investors could profit from buying a potential takeover target. He then revealed a list of technology stocks that he believes might be acquired.

Spotting takeover targets can be a great way to make some mad money, and Cramer can teach you how to look for these targets. But we got a bunch of emails questioning the mechanics surrounding these deals. So let's tackle those issues.

#### Take Me, I'm Yours

Before we dive in to the details, first know that there's a difference between a merger and an acquisition. A merger is basically the mutual decision of two companies that want to combine and become one entity. It's a decision of "equals."

As you can imagine, two companies teaming up and agreeing that they're true equals doesn't happen often. In fact, a lot of the times you hear the term "merger," it's actually a takeover that's occurring.

A takeover, or acquisition, happens when a smaller company is purchased by a bigger one. In his recent "Mad Money" show, Cramer was referring to smaller companies that he thought were going to be acquired. And he suggested that owning shares in these little companies could be a big boon if they were scooped up.

That's because in most instances, the purchasing company offers some sort of premium for the little guy's shares. If the takeover turns into a bidding war with other potential buyers, the premium could get pretty high.

Clearly, there's money to be made. But, ideally, you need to be in the shares of the acquisition target's stock before the market catches on.

That's because the market is reactionary. If it's excited about this upcoming acquisition, the stock will probably jump on the news. So sure, you can still buy the stock after the deal is announced, but much of the upside may already be built into the share price.

But even without a formal announcement, the rumor mill can push the stock price up as well, notes Christopher Kummer, director of the Institute of Mergers, Acquisitions and Alliances in Vienna, Austria.

So the real trick is to get in the stock before market rumblings about a possible acquisition jack up a stock. That's why Cramer shared his list of possible takeover targets. At this point, there's very little takeover noise surrounding these little companies, so if you believe skeedaddy's logic, then now's the time to get in.

Of course, nothing is a sure thing. The company you bet on may never be acquired. Even if a deal is reached, it's not 100% certain to come to fruition. For instance, one of the biggest merger blowups in recent years came when General Electric (GE) agreed to buy Honeywell (HON) in 2000. The European Commission ended up putting the kibosh on the deal because of concerns it would create a monopoly for aerospace and engine products.

And regulatory approvals aren't the only hurdle. There may be legal obstacles or other conditions that need to be met to finalize the transaction, reminds Kummer.

The bigger company also has to do its research on the little guy. So while the big legal and accounting folks are analyzing the little company's books, they may come across a skeleton in the closet that forces the big company to lower the price or even walk away.

That's why it's imperative you only use your "mad money" on these acquisitions plays -- please, no retirement funds -- and understand the risks.

### The Devilish Details

While you may see a big payday, owning a stock that's acquired could also make for some messy record keeping.

Depending on the acquisition, there may be a "record date," says Stevie D. Conlon, senior tax analyst for CCH Capital Changes, a company that provides coverage of corporate actions affecting publicly traded companies. That's the day you have to be a shareholder to partake in the deal. So make sure you own the stock well before that.

After the deal is finalized, make sure you ask two questions: "What do I get from this deal?" and "Is it taxable?"

First, what are you getting? If your stock is acquired by another company, there are a few things you can end up with: cash for your shares, new shares of the bigger company that will replace your old ones or a combination of both.

With a cash purchase, the buyer just gives you cash, and you're done with the investment. So take your money and run. (Big note: In cash deals, it generally doesn't matter when you buy into the stock, so there's no record date. You'll most likely get your cash regardless.)

With a stock deal, you'll render your old shares and get new shares in the bigger company. This is where things get hairy, because you'll probably have to recalculate the basis for your new shares. That's accounting-speak for spreading the original cost of your shares of the little company over the new shares you got from the deal.

Let's presume you spent \$100 on your four shares of the stock that was just acquired. You paid \$25 per share. So \$25 is your basis in each share.

As part of the deal, you got two shares of the purchasing company for every single little share you had. So instead of four little shares, you now have eight big-company shares. Since you originally spent \$100 to get those four shares, you have to spread that original \$100 over your new shares. So your new basis in each of those new shares is \$12.50 (\$100 divided by eight).

Next, is the deal taxable?

If the deal is taxable, you'll owe capital gains tax on the fair market value of the new shares you get, less your basis. So in our example, you'll owe tax on the difference between the current share price and your basis of \$12.50.

If the deal is tax-free, you'll still have to readjust your basis, but you won't have a tax bill until you sell those new shares. That's why tax-free deals are much better for investors. It allows them more control over their tax situation.

Another tax-free perk is that your holding period is carried over, says Conlon. So if you bought your original shares two years ago, it will be assumed that you've been holding the new shares for two years as well.

Hopefully the company's Web site details the tax implications of the deal and properly holds your hand through the transaction.

If not, use GainsKeeper.com. The site keeps track of all merger and acquisition activity and will recalculate your basis for you. Just input all your current holdings and let it take care of the tax stuff.

So be on the lookout for takeover targets. Cramer believes Palm (PALM) is a good takeover target on Wall Street. I think Pamela Anderson is next on the Hollywood list. Her recent marriage to Kid Rock is likely to be over by the end of August.

Tracy Byrnes is an award-winning writer specializing in tax and accounting issues. As a freelancer, she has written columns for wsj.com and the New York Post and her work has appeared in SmartMoney and on MarketWatch. Prior to freelancing, she spent four years as a senior writer for TheStreet.com. Before that, she was an accountant with Ernst & Young. She has a B.A. in English and economics from Lehigh University and an M.B.A. in accounting from Rutgers University. Byrnes appreciates your feedback; click here to send her an email.