Tax Considerations in M&A Transactions

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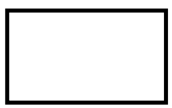
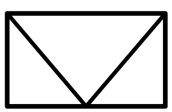
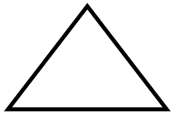
Diagram Legend



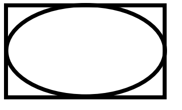
C corp for U.S. federal income tax purposes



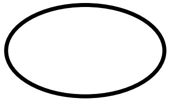
S corp for U.S. federal income tax purposes



Partnership for U.S. federal income tax purposes



Disregarded entity for U.S. federal income tax purposes



Individual or individuals

General Topics

- S Corp Target Structures
- Equity Rollover Structures
- Section 1202 Considerations
- Other M&A Considerations

S Corp Acquisition Structures

- <u>Shareholder Tax Objectives in Taxable Acquisitions</u>:
  - Long-term capital gain (19.6% rate difference) (gross up).
  - Minimize state income taxes (apportionment of gain) (gross up).
  - Defer gain recognition with respect to rollover equity (Section 351 or Section 721 exchange).
  - Defer gain recognition with respect to deferred payments (installment sale).
  - Obtain tax benefit of transaction expense deductions.

- <u>Buyer Tax Objectives in Taxable Acquisitions</u>:
  - Obtain step-up in tax basis of target's assets.
  - Avoid S corp status risk with respect to the asset basis step-up.
  - Interest in maintaining FEIN of target.
  - Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition Structures

- Taxable S Corp Acquisition Structures:
  - Stock Purchase (*not* making Section 338(h)(10) or Section 336(e) election to treat as an asset sale).
  - Stock Purchase (making Section 338(h)(10) or Section 336(e) election to treat as an asset sale).
  - Asset Purchase (S corp does not liquidate).
  - Pre-Closing F Reorganization (deemed asset sale treatment).
  - Pre-Closing F Reorganization (sale of partnership interest / Section 754 election).

S Corp Acquisition Structures

- <u>Stock Purchase (*not* making a Section 338(h)(10) or 336(e) election)</u>:
  - <u>Shareholder Tax Objectives</u>:
    - ☑ Long-term capital gain (19.6% rate difference).
    - ☑ Minimize state income taxes (apportionment of gain).
    - ☑ Defer gain recognition with respect to rollover equity (Section 351 or 721 exchange).
    - ☑ Defer gain recognition with respect to deferred payments (Section 453).
    - ☐ Obtain tax benefit of transaction expense deductions.

  - <u>Buyer Tax Objectives</u>:
    - ☐ Obtain step-up in tax basis of target's assets.
    - ☐ Avoid S corp status risk with respect to the step-up in tax basis.
    - ☑ Maintain FEIN of target.
    - ☑ Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition Structures

- Stock Purchase (making a Section 338(h)(10) or 336(e) election):
  - Shareholder Tax Objectives:
    - ☑ Long-term capital gain (19.6% rate difference) (some ordinary income).
    - ☐ Minimize state income taxes (apportionment of gain).
    - ☐ Defer gain recognition with respect to rollover equity (Section 351 or 721 exchange).
    - ☐ Defer gain recognition with respect to deferred payments (Section 453) (acceleration trap on deemed liquidation).
    - ☑ Obtain tax benefit of transaction expense deductions.
  - Buyer Tax Objectives:
    - ☑ Obtain step-up in tax basis of target's assets.
    - ☐ Avoid S corp status risk with respect to the step-up in tax basis.
    - ☑ Maintain FEIN of target.
    - ☑ Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition Structures

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    - ☐ Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition Structures

- Pre-Closing F Reorg (deemed asset sale; S corp not liquidated):
  - Shareholder Tax Objectives:
    - ☑ Long-term capital gain (19.6% rate difference) (some ordinary income).
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S Corp Acquisition Structures

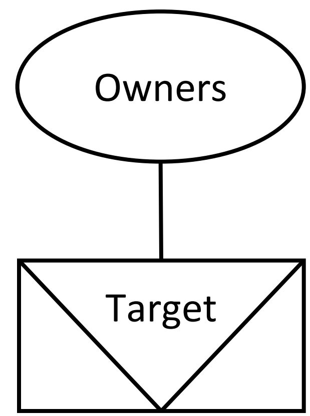
- Pre-Closing F Reorg (partnership interest purchase; S corp not liquidated):
  - Shareholder Tax Objectives:
    - ☑ Long-term capital gain (19.6% rate difference) (some ordinary income).
    - ☑ Minimize state income taxes (apportionment of gain).
    - ☑ Defer gain recognition with respect to rollover equity (Section 351 or 721 exchange).
    - ☑ Defer gain recognition with respect to deferred payments (Section 453).
    - ☑ Obtain tax benefit of transaction expense deductions.

  - Buyer Tax Objectives:
    - ☑ Obtain step-up in tax basis of target's assets.
    - ☑ Avoid S corp status risk with respect to the step-up in tax basis.
    - ☑ Maintain FEIN of target.
    - ☑ Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition
F Reorganization

Initial Target Structure:

Certain individuals (the "**Owners**") own all of the equity of an entity taxed as an S corp ("**Target**").



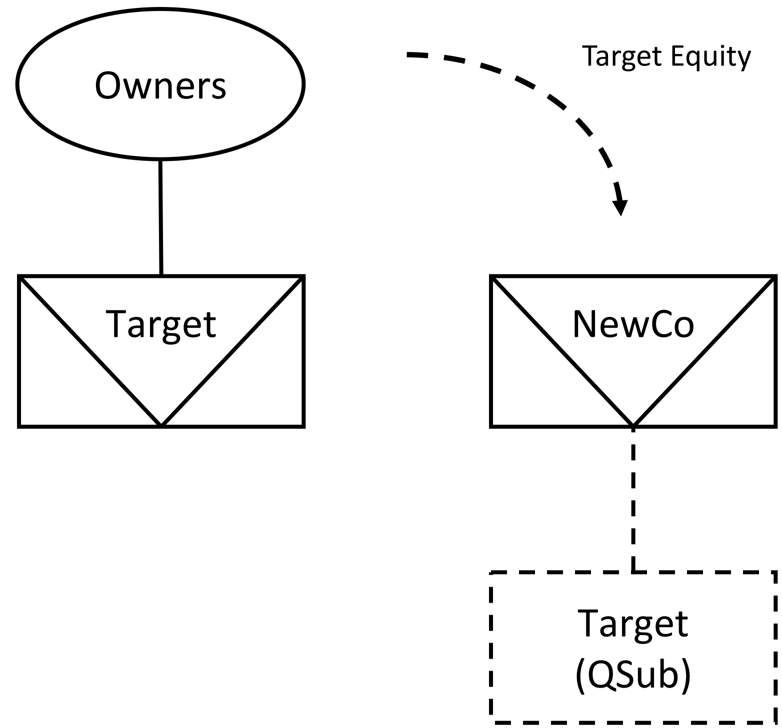
S Corp Acquisition F Reorganization

F Reorg:

Step 1: The Owners form a new corporation or a limited liability company that elects to be taxed as a corporation ("**NewCo**") and contribute all of their equity in Target to NewCo in exchange for Newco equity.

Step 2: NewCo elects to treat Target as a qualified subchapter S subsidiary ("**QSub**").

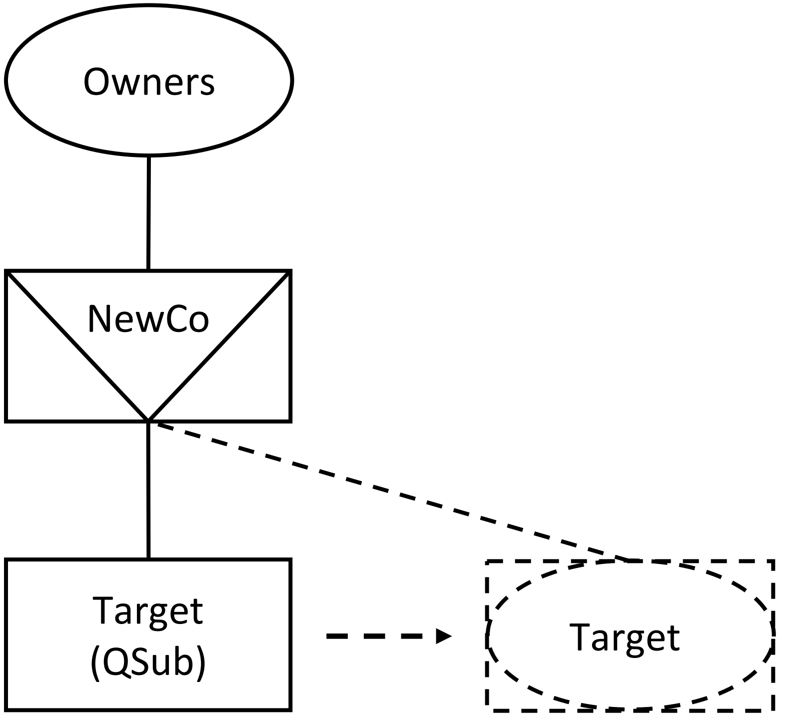
The contribution and QSub election are treated as an F Reorganization transaction described in Rev. Rul. 2008-18. NewCo is a continuation of Target for federal income tax purposes. NewCo is required to obtain a new EIN and Target retains its EIN.



S Corp Acquisition
F Reorganization

Creation of Disregarded Entity:

Step 3: Target becomes a disregarded entity for federal income tax purposes through one of the following: (1) a check-the-box election (if Target is not a per se corporation); (2) a state law conversion; or (3) a merger.



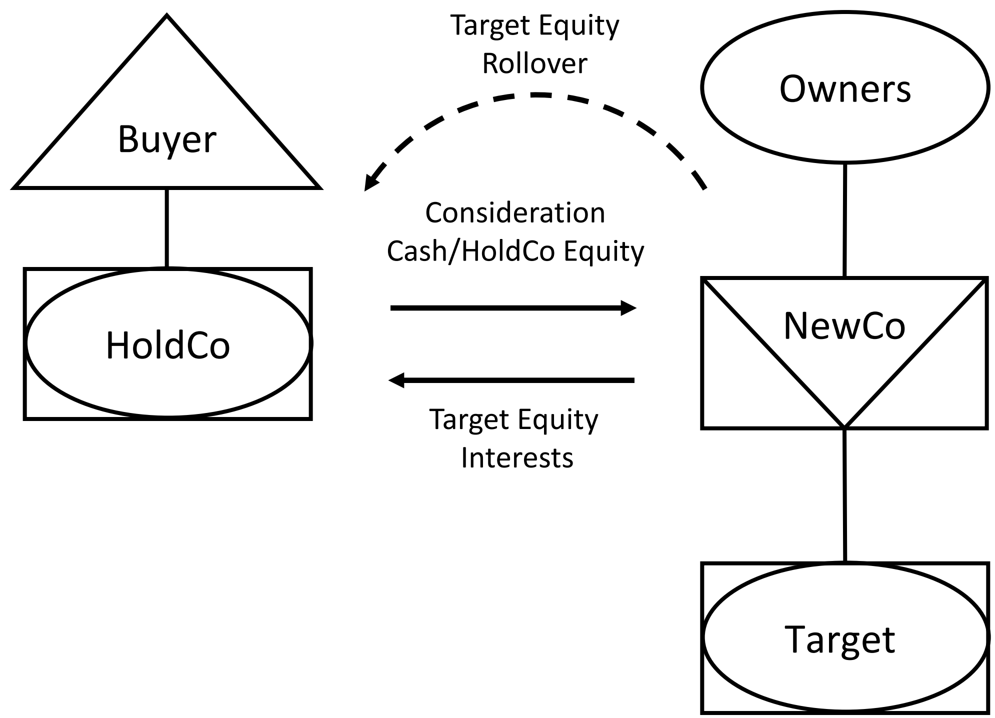
S Corp Acquisition
F Reorganization

Acquisition:

A subsidiary of the Buyer (“**HoldCo**”) acquires all of the equity interests of Target in exchange for cash and rollover equity.

The transaction is treated as a part sale, part contribution of the assets of Target.

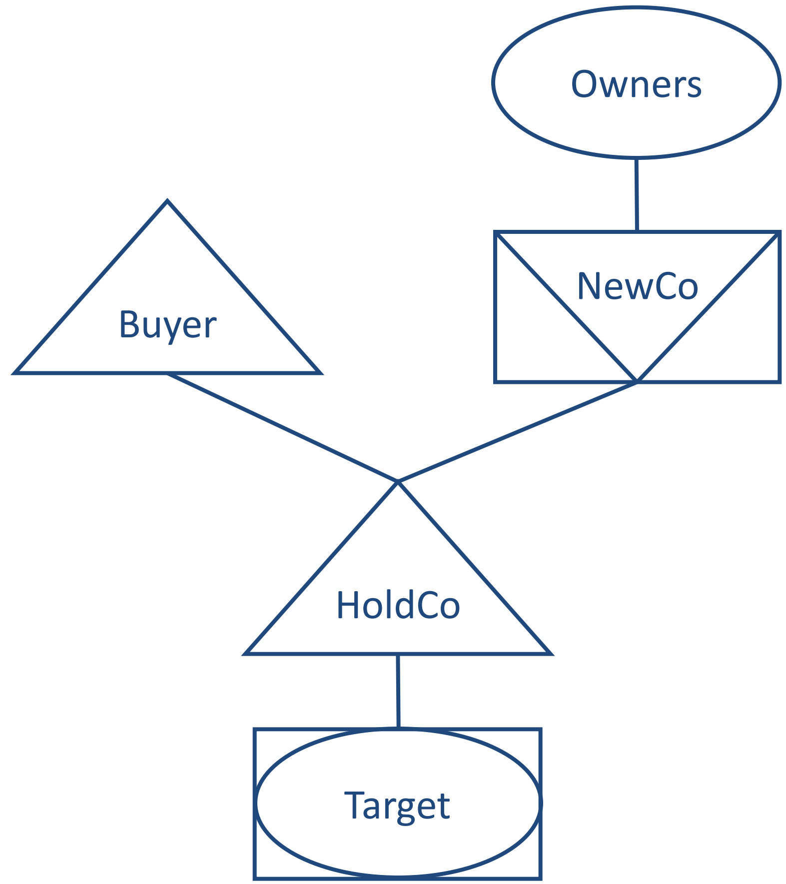
Alternatively, Buyer could directly acquire less than 100% of the equity of Target.



S Corp Acquisition F Reorganization

Post-Acquisition Final Structure:

Sales proceeds are distributed to Owners and NewCo continues to hold the rollover equity and deferred payment consideration.



S Corp Acquisition F Reorganization

- F Reorg Acquisition Structure Considerations:
- Section 704(c) allocation method (traditional vs. remedial).

- Newco (S corp) remains in existence and does not liquidate.
  - Avoids triggering gain on equity consideration.
  - Avoids acceleration of gain under installment method.

- Historic tax liabilities (same as with any equity interest acquisition).

- No partial redemptions with cash proceeds.

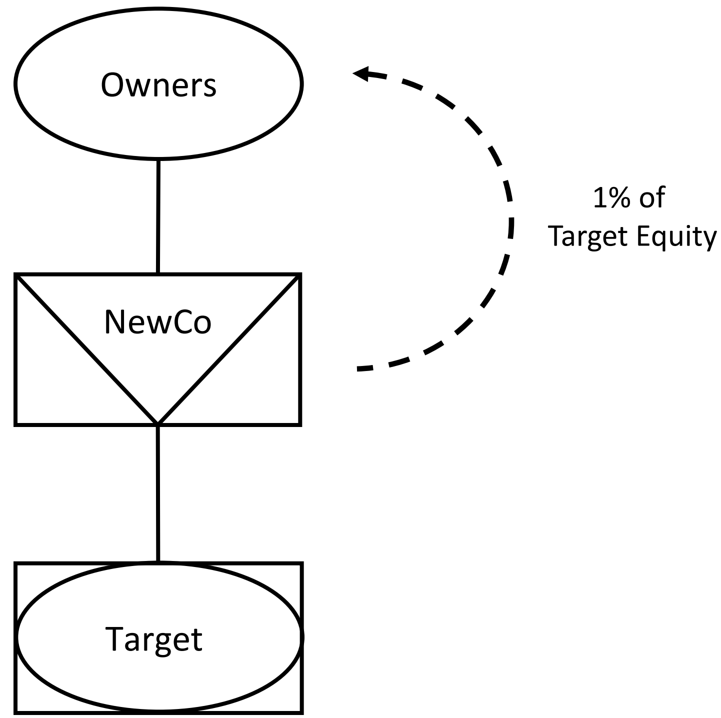
Objectives Achieved

- Pre-Closing F Reorg (deemed asset sale; S Corp not liquidated):
  - Shareholder Tax Objectives:
    - ☑ Long-term capital gain (19.6% rate difference) (some ordinary income).
    - ☐ Minimize state income taxes (apportionment of gain).
    - ☑ Defer gain recognition with respect to rollover equity (Section 351 or 721 exchange).
    - ☑ Defer gain recognition with respect to deferred payments (Section 453).
    - ☑ Obtain tax benefit of transaction expense deductions.
  - Buyer Tax Objectives:
    - ☑ Obtain step-up in tax basis of target's assets.
    - ☑ Avoid S corp status risk with respect to the step-up in tax basis.
    - ☑ Maintain FEIN of target.
    - ☑ Third-party consents and regulatory issues (non-tax consideration).

S Corp Acquisition F Reorganization / Partnership

Additional Step 4:

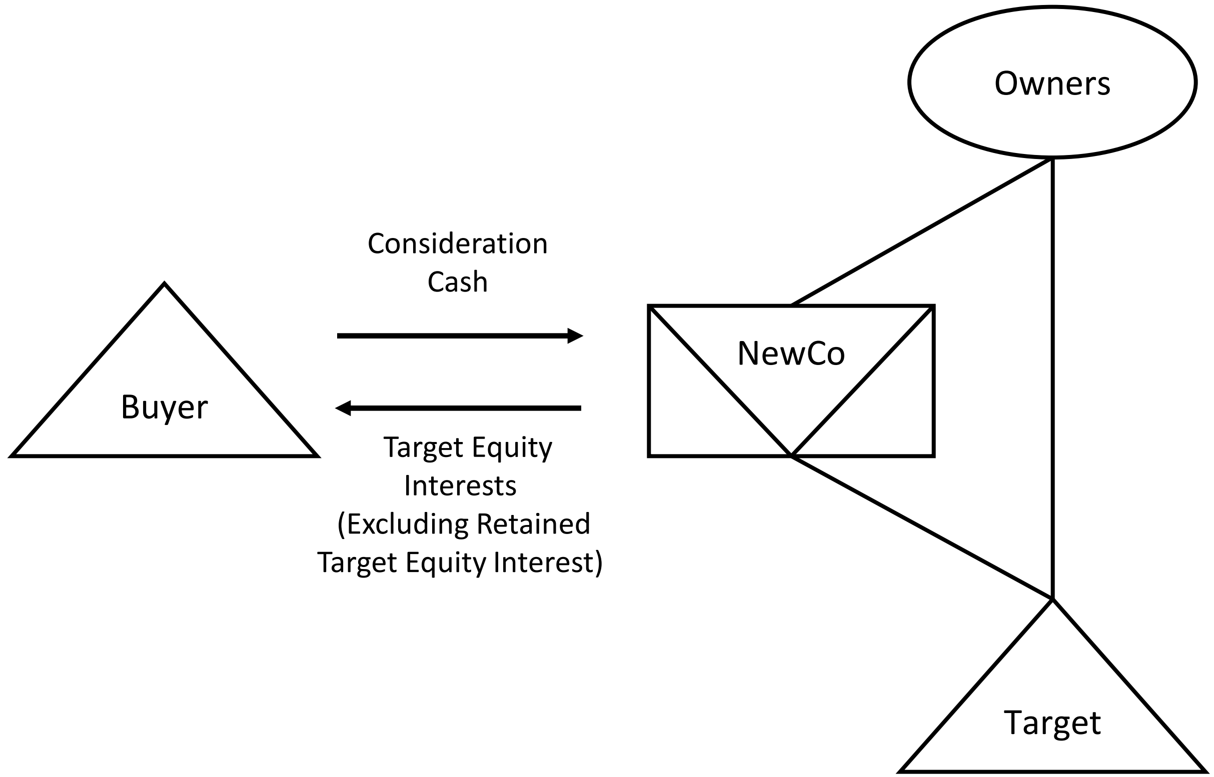
Following completion of Steps 1 through 3 (See Slides 12 and 13), NewCo distributes an equity interest (typically 1%) in Target to the Owners for the purposes of converting Target into a partnership for income tax purposes.



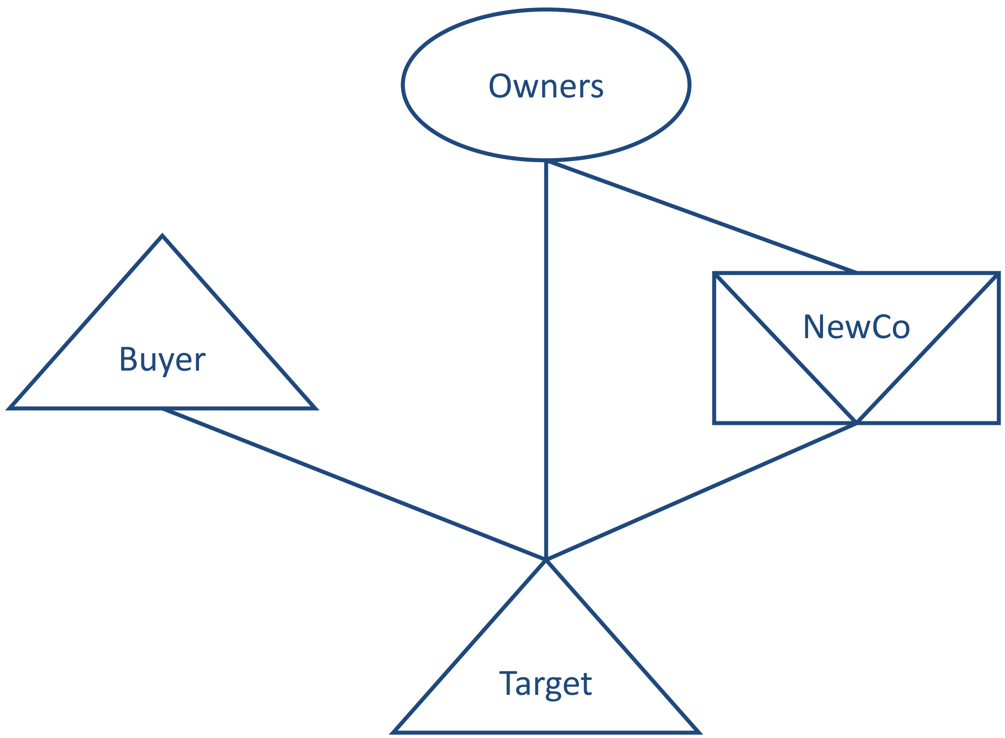
S Corp Acquisition
F Reorganization / Partnership

Acquisition:

Buyer acquires purchased equity interests of Target held by NewCo in exchange for cash. NewCo retains "rollover" interest in Target.



S Corp Acquisition
F Reorganization / Partnership



S Corp Acquisition
F Reorganization / Partnership

- F Reorg Acquisition/Partnership Structure Considerations:
- Distribution of the 1% interest is treated as a taxable sale of a 1% undivided interest in the S corp assets (Slide 28).
- New depreciable asset lives resulting from 708(b)(1)(B) termination of partnership.
- Buyer is permitted to capture the full benefit of the step-up in tax basis under Section 743 and avoid Section 704(c) allocation method considerations and complexity.
- Sale of partnership interest may avoid apportionment of gain for state income tax purposes. Gain arising from the sale of partnership interests is typically sourced to the seller's state of residence.

S Corp Acquisition
F Reorganization / Partnership

- F Reorg Acquisition/Partnership Structure Considerations (cont.):
- Section 197 anti-churning issues are eliminated. In a structure treated as an asset sale, anti-churning concerns could arise if the rollover is more than 20%.
- Newco (S corp) remains in existence and does not liquidate.
  - Avoids triggering gain on equity consideration.
  - Avoids acceleration of gain under installment method.
- Historic tax liabilities follow (same as with any equity interest acquisition).
- No partial redemptions with cash proceeds.

Objectives Achieved

- Pre-Closing F Reorg (partnership interest purchase; S Corp not liquidated):
  - Shareholder Tax Objectives:
    - ☑ Long-term capital gain (19.6% rate difference) (some ordinary income).
    - ☑ Minimize state income taxes (apportionment of gain).
    - ☑ Defer gain recognition with respect to rollover equity (Section 351 or 721 exchange).
    - ☑ Defer gain recognition with respect to deferred payments (Section 453).
    - ☑ Obtain tax benefit of transaction expense deductions.

  - Buyer Tax Objectives:
    - ☑ Obtain step-up in tax basis of target's assets.
    - ☑ Avoid S corp status risk with respect to the step-up in tax basis.
    - ☑ Maintain FEIN of target.
    - ☑ Third-party consents and regulatory issues (non-tax consideration).

Section 338(h)(10) Election Installment Sale Trap

<u>Basis Allocation Problem / Acceleration of Gain on Liquidation</u>:

When an S corp sells its assets and liquidates (or is deemed to sell its assets and liquidate under Section 338(h)(10) or Section 336(e)), Sections 331 applies to the shareholders with respect to the liquidation.

Section 331 generally requires Section 1001 sale or exchange treatment to the shareholder with respect to the assets distributed (e.g., notes or other deferred payment obligations).

Section 453(h), in a liquidation to which Section 331 applies, generally treats payments under the installment obligation (not the obligation itself) as payments received by the shareholders in exchange for the shareholders' stock (i.e., permits shareholders to use the installment method).

Section 338(h)(10) Election Installment Sale Trap

Basis Allocation Problem / Acceleration of Gain on Liquidation (cont.):

Section 453B(h) provides that no gain or loss will be recognized by an S corp with respect to the distribution of an installment obligation in complete liquidation if such obligation is not treated as payment for the shareholders' S corp stock under Section 453(h).

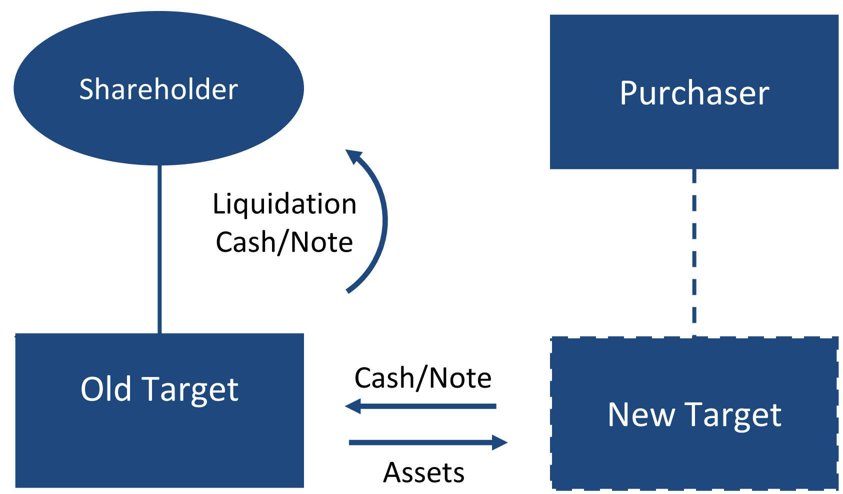
Problem: Liquidation of the S corp actually accelerates more gain than if the S corporation did not liquidate until receiving all the installment payments. The installment method basis allocation rules require stock basis (adjusted for gain recognized at the S corp level in connection with the deemed sale of assets) to be allocated among all assets, including cash, received in liquidation (i.e., cash doesn't first reduce basis under Section 1368(b)). See Reg. Section 1.338(h)(10)-1(e), Ex. 10.

S Corp Target – Example #1 Installment Sale Trap

<ins>Example</ins>: S corp target has one individual shareholder. Purchaser (C corp) is willing to acquire the target for $20M cash plus a deferred payment obligation of $5M. The shareholder and the purchaser agree to structure the transaction as a deemed asset sale under a Section 338(h)(10) transaction structure. For simplicity, assume the following with respect to the S corp target: stock and asset basis is zero, no S corp indebtedness, no transaction expenses and the installment method is available with respect to the deferred payment obligation.

S Corp Target – Example #1
Installment Sale Trap

Income tax treatment of the sale of S corporation stock with a Section 338(h)(10) election.



S Corp Target – Example #1 Installment Sale Trap

S Corp Gain on Deemed Asset Sale:

S corp target is treated as receiving $20,000,000 in cash and a $5,000,000 installment note in exchange for assets.

Selling Price	$25,000,000
Basis	$0
Gross Profit	$25,000,000

- Gross Profit Percentage = 100%
- The S corp recognizes gain of $20,000,000 (100% x $20,000,000) that flows through to the shareholder and increases stock basis.

S Corp Target – Example #1
Installment Sale Trap

Shareholder Gain on Deemed Liquidation:

S corp shareholder receives the $20,000,000 in cash and the $5,000,000 installment note in liquidation of the S corp. Treated as an installment sale of the stock under Section 453(h).

Selling Price	$25,000,000
Basis	$20,000,000
Gross Profit	$5,000,000

- Gross Profit Percentage = $5,000,000 / $25,000,000 = 20%.
- Stock basis allocated to cash = $16,000,000 (80% x $20,000,000).
- Stock basis allocated to note = $4,000,000 (80% x $5,000,000).

S Corp Target – Example #1
Installment Sale Trap

Shareholder Gain on Deemed Liquidation (cont.):

- Gain of $4,000,000 (20% x $20,000,000) is accelerated on deemed liquidation.
- Total recognized gain = $20,000,000 + $4,000,000 = $24,000,000.
- The portion of the gain that could be deferred (or go unrecognized, for example, if the note is contingent and does not become payable) = $4,000,000.
- Capital loss in subsequent tax period (contingent payment obligation).

S Corp Target
Installment Sale Trap

Ways to Possibly Avoid Trap:

- S corp does not liquidate (e.g., F Reorg structures; asset sale).
- S corp liquidates (e.g., S corp is deemed to liquidate as a result of a Section 338(h)(10) or 336(e) election).
  - Substitute one-week note for cash portion of purchase price.
    - Will note be respected?
  - Obtain standby letter of credit as security.
  - Distribute existing cash prior to liquidation (Section 1368(b) treatment?).
    - Will distribution be viewed as part of liquidation?

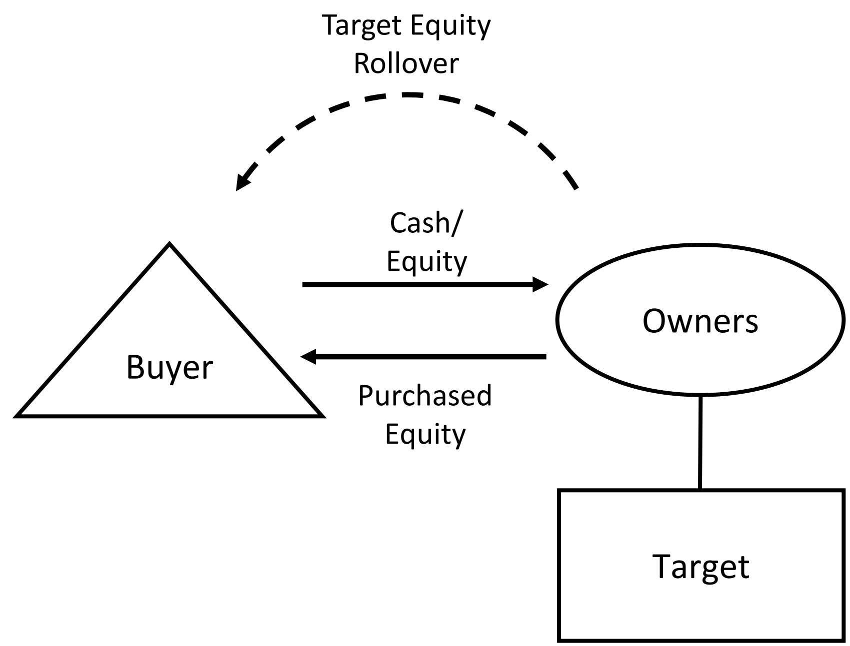
Rollover Structures

- Typically, a rollover structure involves an equity acquisition structure where the target equityholders acquire an equity interest in the buyer or its controlling parent by "rolling over" (typically on a tax-deferred basis under Section 721 or Section 351) a portion of their equity interest in the target.

- A rollover may also be effected through the retention of equity interests in the target.

Rollover into a Partnership

An acquiring entity taxed as a partnership is a more flexible vehicle for rollover structures compared to an acquiring entity taxed as a corporation. Generally, under Section 721, no gain or loss is recognized as a result of a contribution of property (e.g., an equity interest in target corp) to a partnership in exchange for an interest in the partnership.



Rollover into a Corporation

Subject to the requirements of Section 351, no gain or loss is recognized as a result of a contribution of property (e.g., an equity interest in target) to a corporation in exchange for stock of the corporation.

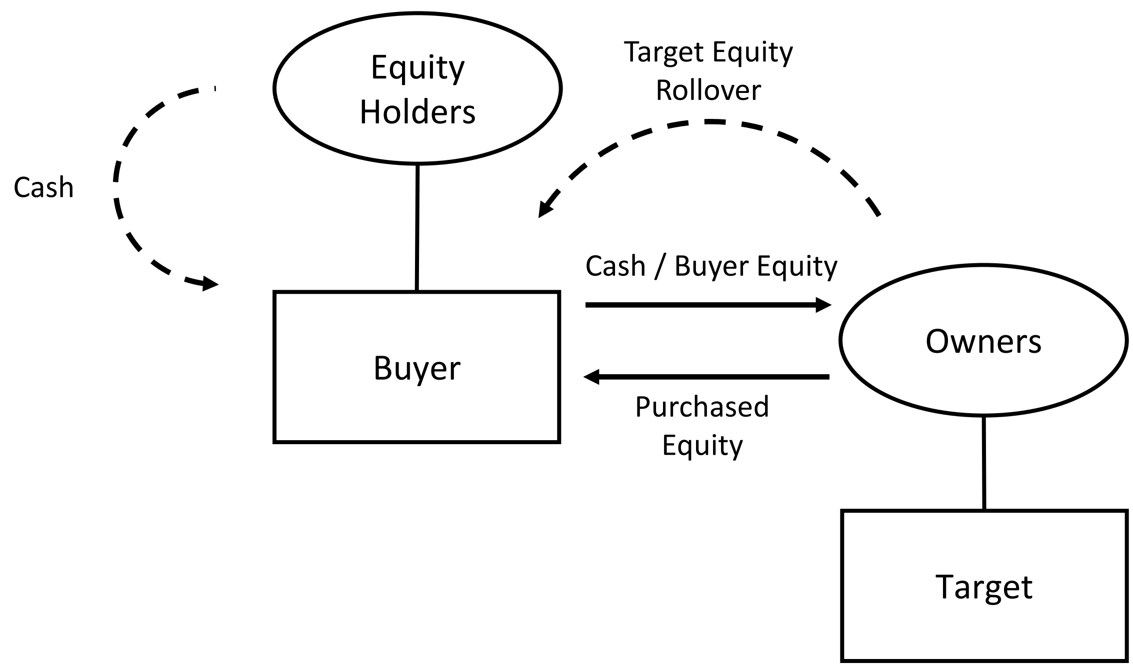
Control: For purposes of Section 351, the person(s) transferring property to a corporation must, immediately after the transfer, control at least 80% of the corporation by vote and value. If shareholders of the buyer are capitalizing the buyer in connection with the transaction, the ownership of those shareholders can be aggregated with the ownership of the rollover participants for purposes of determining whether this 80% threshold is met.

Rollover into a Corporation

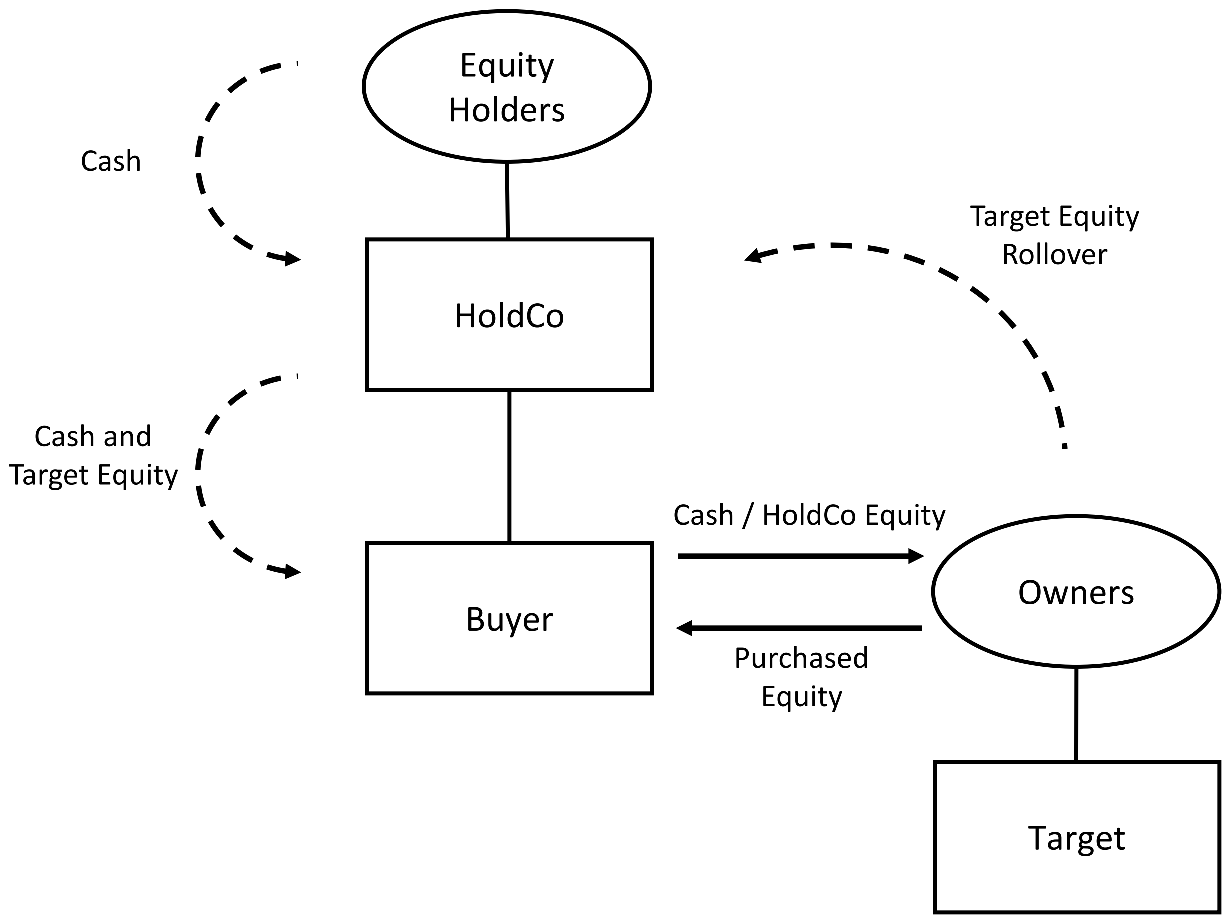
- “Back-Loaded” Basis Problem: A transferor receiving cash or property other than stock (i.e., “boot”) in a transaction governed by Section 351 must, up to the amount of realized gain with respect to all the target equity, recognize gain to the extent of cash and the fair market value of other property received. A two-tiered acquisition structure may be used to address “back-loaded” basis concerns.

- Example: Owner owns stock worth $1,000 with a tax basis of $200. Buyer, in a Section 351 exchange, acquires all of Owner’s stock in exchange for $700 in cash and Buyer stock worth $300. Owner’s realized gain is $800. Owner must recognize $700 of his realized gain. Owner’s Buyer stock takes on a substituted basis of $200.

Rollover into a Corporation – Example (One Tier)



Rollover into a Corporation – Example (Two Tier)



Section 1202

- Section 1202 – Qualified Small Business Stock ("QSB Stock").
- Gain from the sale of QSB Stock may qualify for a 100% exclusion from (i) the regular federal income tax, (ii) the alternative minimum tax, and (iii) the 3.8% net investment income tax.

Section 1202

- <u>General Requirements</u>:
  - Stock holding period begins after September 27, 2010 (100% exclusion).
  - Stock must be held for more than five years following date of issuance.
  - Redemptions of stock may cause a problem (2-year and 4-year window rules).
  - Exclusion applies only to non-corporate taxpayers (i.e., individuals, trusts and estates).
  - Issuer must be a domestic C corporation.
  - Stock must be acquired at original issuance for cash or other property (generally, other than stock) or as compensation for services to the C corporation.
  - Active business requirement (i.e., 80% of assets must be used in a qualifying “active business” for substantially all of the taxpayer’s holding period; generally, trades or businesses where the principal asset is the reputation or skill of one or more employees do not qualify; other specifically listed businesses do no qualify).

Section 1202

- <u>General Requirements (cont.)</u>:
  - The C corporation must consent to supply documentation to the IRS and the shareholders as the IRS may prescribe.
  - The aggregate gross assets (i.e., cash plus the aggregate adjusted tax basis of other property, other than contributed property which is taken into account at date of contribution value) held by the qualified small business must not exceed $50 million at any time before *<u>or</u>* immediately following the investment by the investor (including amounts received by the qualified small business from the investor).
  - For each corporation in which a taxpayer invests, the total amount of gain eligible for the Section 1202 exclusion for a tax year may not exceed the greater of (i) $10 million ($5 million for married persons filing separately) reduced by the taxpayer's total gain on dispositions of the corporation's stock taken into account in earlier years; or (ii) ten (10) times the aggregate adjusted basis of any of the corporation's QSB Stock that taxpayer disposed of during the year, but not including any additions to basis after the date it was originally issued.

Section 1202 - Example

Eligible Gain Example:

A purchases QSB Stock in X corporation for $500,000 on 11/1/2010 and purchases QSB Stock in Y corporation for $2,000,000 on 2/1/2011. X corporation and Y corporation are not related.

In 2017, A sells all of her X corporation stock for $12,000,000 and all of her Y corporation stock for $14,000,000. All Section 1202 requirements are met. A files a joint federal income tax return with her spouse.

A's gain with respect to the X corporation stock, up to $10,000,000, is subject to gain exclusion under Section 1202. The 100% exclusion applies based on the date of original issuance to A. A excludes $10,000,000 of her gain of $11,500,000 from 2017 gross income, AMTI and the NIIT and recognizes $1,500,000 of the gain.

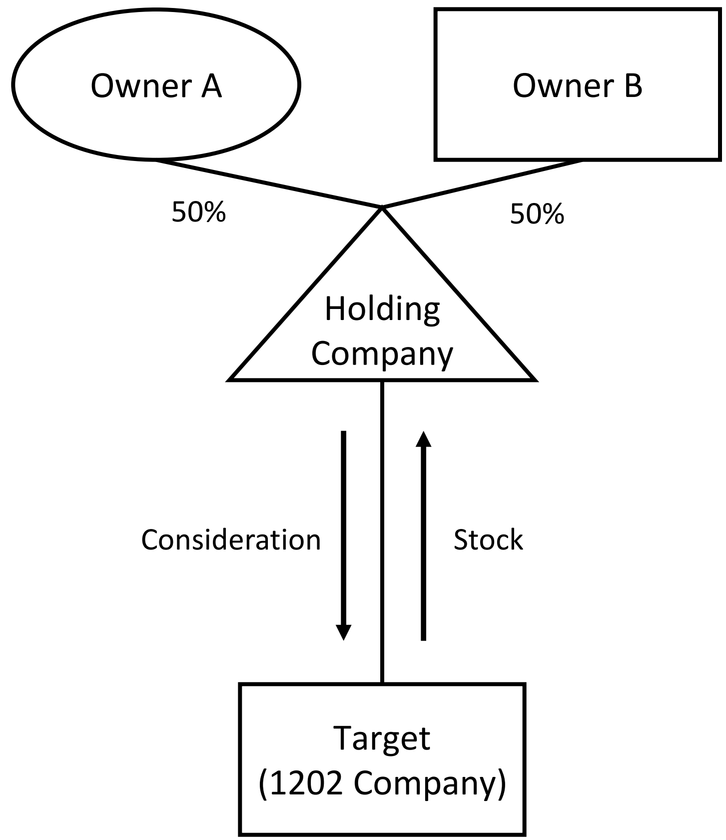
A's gain with respect to the Y corporation stock, up to $20,000,000, is subject to gain exclusion under Section 1202. The 100% exclusion applies based on the date of original issuance to A. A excludes all $12,000,000 of the gain from 2017 gross income, AMT and the NIIT.

Section 1202

- Treatment of Sale of QSBS by Pass-Through Entities (S corps, partnerships, RICs and common trust funds):
  - QSB Stock must be issued directly to the pass-through entity and cannot be placed into the pass-through entity after being issued.
  - Gain must be attributable to QSB Stock (determined as though the pass-through entity was an individual) held by the pass-through entity for more than five years.
  - Gain excluded must be includible in taxpayer’s gross income by reason of holding an interest in the pass-through entity, which was held on the date the pass-through entity acquired the stock and at all times thereafter.
  - Gain excluded must be based on the interest in the pass-through entity held by taxpayer when the QSB Stock was acquired by the pass-through entity.

Section 1202 - Example

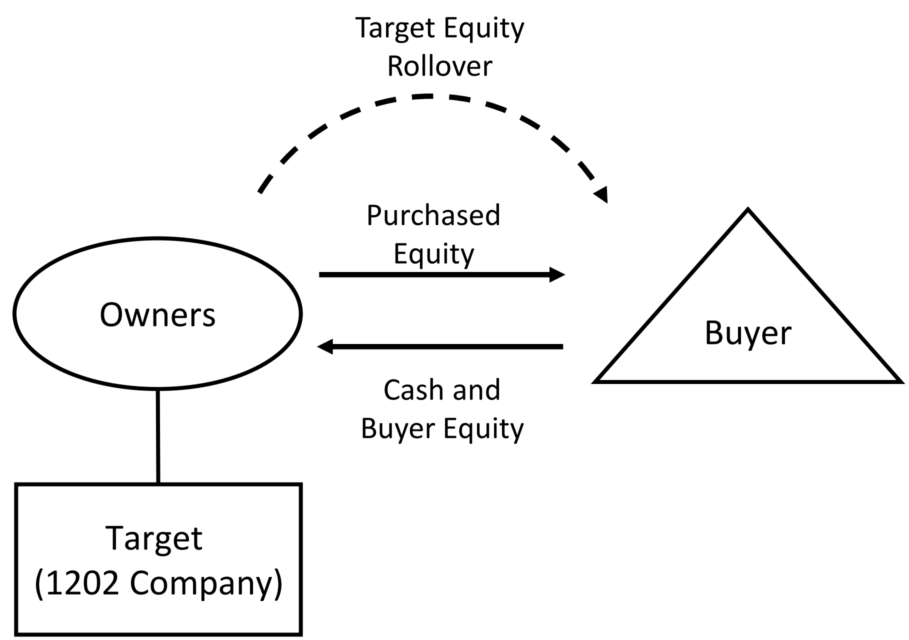
Owner A's 1202 gain exclusion must be based on Owner A's 50% interest in Holding Company at the time of Holding Company's acquisition of 1202 stock (e.g., if Owner A acquired 25% of his 50% interest after issuance of the QSBS, the gain exclusion amount continues to be based on Owner A's original 25% interest).



Section 1202 - Example

The transfer of shares of QSB Stock into an entity taxed as a partnership or an S corp after acquiring the QSB Stock will result in loss of QSB Stock qualification with respect to such transferred shares.

The Owners place the QSB Stock of Target into the Buyer partnership and receive partnership interests in Buyer in connection with the acquisition structure shown here. This transaction structure results in the loss of QSB Stock status.



Section 1202

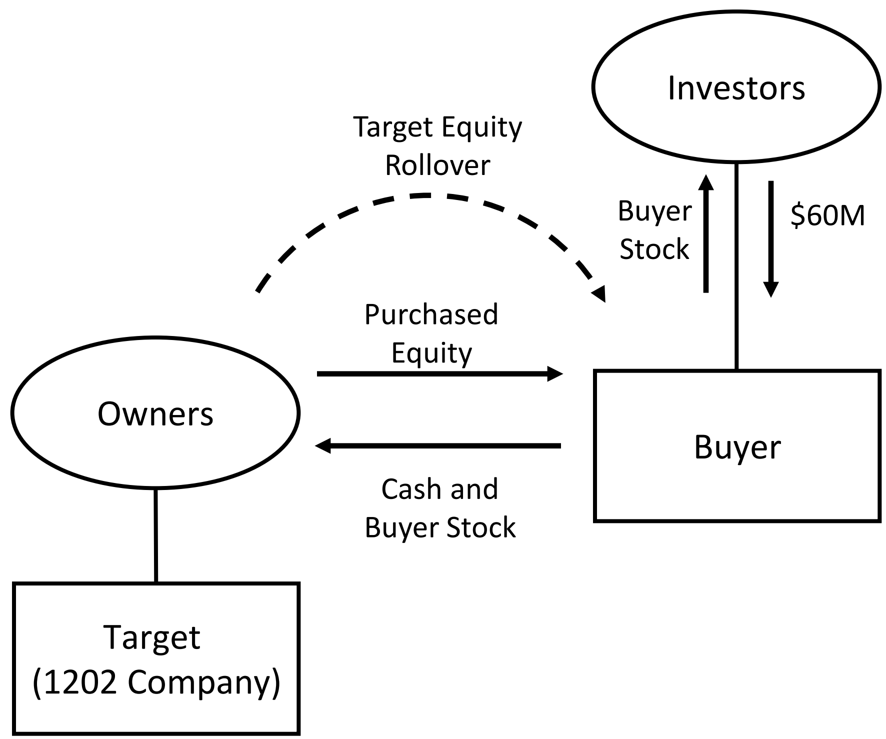
- Incorporations and Reorganizations:
  - QSB Stock received in exchange for stock issued by a corporation that is a "qualified small business" in a Section 351 transaction or a Section 368 reorganization will be treated as QSB Stock acquired on the date the exchanged QSB Stock was acquired. In Section 351 transaction, the transferee corporation must have direct or indirect "control" (80% vote/value) of the corporation whose stock was exchanged.
  - If the issuing corporation in the Section 351 transaction or Section 368 reorganization is not a "qualified small business," the amount of gain eligible for exclusion is limited to the gain that would have been excluded on the date of the transfer if Section 351 or Section 368 had not applied.

Section 1202 - Example

Assume Buyer receives cash of $60M from Investors to fund the acquisition.

The Owners receive cash and rollover equity in Buyer in a Section 351 exchange.

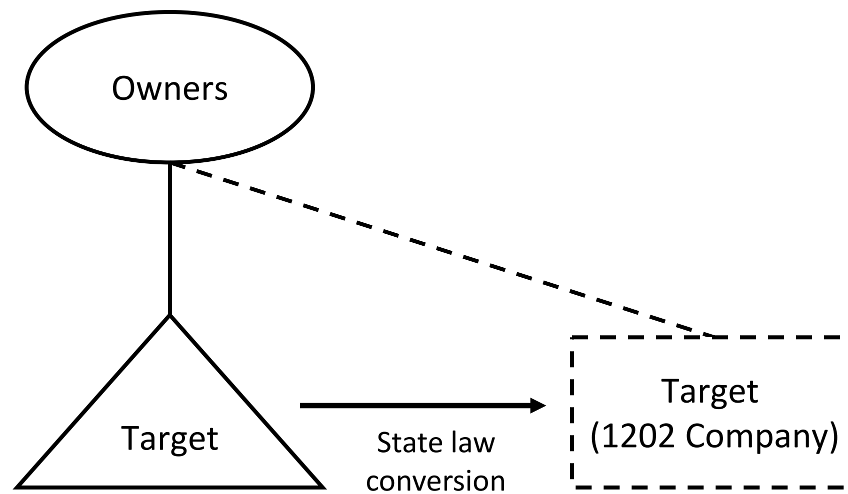
Since Buyer is not a “qualified small business,” the Section 1202 gain exclusion inherent in the Buyer stock received by the Owners in the Section 351 exchange is limited to the amount of gain that would have been excluded on the date of the Section 351 exchange.



Section 1202 - Example

The Owners convert an LLC taxed as a partnership into a C corporation that is a "qualified small business." LLC interests are converted into stock.

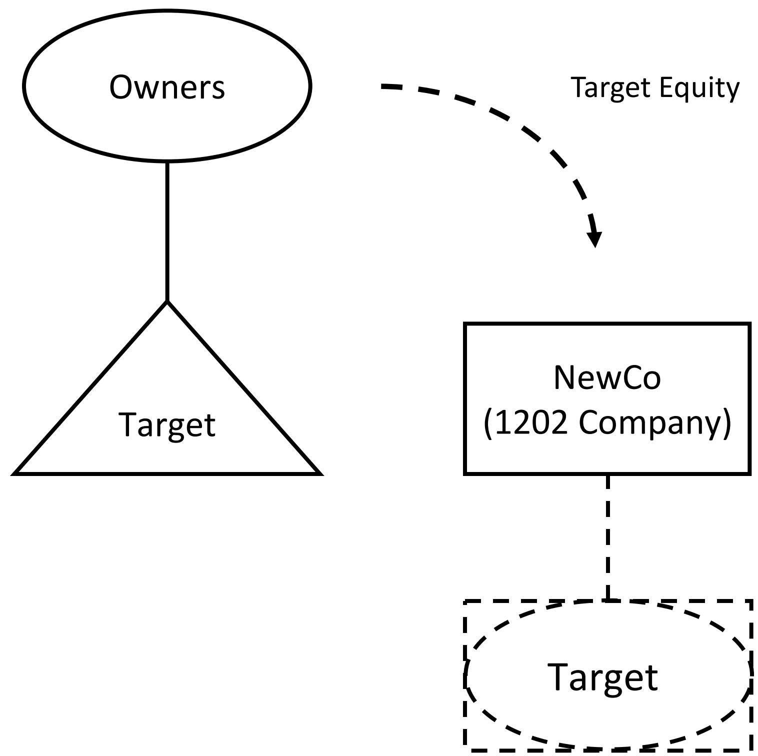
For purposes of the Section 1202 five-year holding period requirement, the holding period begins on the date of the conversion and does not tack.



Section 1202 - Example

The Owners contribute all of the equity of an LLC taxed as a partnership to a newly-formed C corporation that is a "qualified small business" in exchange for the stock of the C corporation.

For purposes of the Section 1202 five year holding period requirement, the holding period begins on the date of the contribution and does not tack.



Other M&A Considerations

- S Corp Qualification Issues.
  - Second class of stock issues.
- Disproportionate Sharing of S Corp Purchase Price (Treas. Reg. Section 1.1361-1(l)(2)).
  - Stock purchase (permitted).
  - Stock purchase with Section 338(h)(10) and Section 336(e) elections (permitted).
  - F Reorg structure (likely not permitted).
- Transaction Deductions (Termination of S Corp Tax Year) (Treas. Reg. 1.1362-2 and 1.1362-3, and Prop. Reg. 1.1502-76(b)).

Other M&A Considerations

- Sales and Use Tax and State Income Tax Compliance.
- Net Investment Income Tax (3.8%) (sale of pass-through entity with "material participation" in the business of the entity).
    - Does not apply to "non-passive" equity holders.
- Failure to make Section 83(b) elections with respect to a "profits interest" subject to a "substantial risk of forfeiture" that is issued within two years preceding disposition of the interest in M&A transaction.
    - Interest falls outside "profits interest" safe harbor under Rev Procs 93-27 and 2001-43.
    - Still subject to forfeiture? Fully vested?

Other M&A Considerations

- Contingent Consideration (employment component).
  - Whether the payment is conditioned on future service.
  - Whether the payment is proportionate to target equity ownership.
  - Presence of reasonable compensation.
  - Whether the payment represents a reasonable valuation for the equity.
  - Will shareholder/employee's departure impact value.
- Tax Treatment of Deferred Revenue.
- Partnership Disguised Sale Rules (Section 707).

Disclaimer

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