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The Latest on Tax Issues in Structuring M&A Transactions

Presented to: Colorado Bar Association CLE

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Introduction

- New Federal Rates and Taxes for 2013
- Structure Planning
  - Basic Partnership Acquisition Structure
  - Basic Taxable Stock Acquisition Structure
  - Management Rollovers
  - Basic Corporate Reorganization Structures
  - Watch Out For Step Transaction Treatment
  - Turning "On" or "Off" Section 351
  - Earn-outs
  - F Reorg. Magic in Private Equity Deals
  - Leveraged ESOPs

NEW FEDERAL RATES AND TAXES

New Federal Income Tax Rates and Taxes for 2013:

- Under the “Fiscal Cliff” deal, individuals filing joint returns with taxable income in excess of $450,000 (indexed for inflation) will be in the maximum income tax bracket of 39.6%, up 4.6% from the prior-law 35% maximum
- The 3.8% NIIT, where applicable, is on top of the regular income tax = 43.4%
- The increase of 0.9% to 3.8% of unlimited SEI for the Medicare tax is also on top of the regular income tax = 43.4%
- The maximum income tax rate on long-term capital gain and qualified dividends increases to 20% from 15% (for those subject to the 39.6% rate on ordinary income) and is increased by the NIIT, where applicable, to 23.8%
- The 35% maximum rate of income tax on C corporations did not change
- The exclusion for 100% of recognized gain on the sale of qualified small business (C corp.) stock acquired before 2014 is extended

New Medicare Contribution Tax on Unearned Income

- IRC §1411, which was enacted in 2010, will impose a 3.8 percent "Medicare contribution tax" on the lesser of an individual's net investment income ("NII") or the excess of the individual's modified adjusted gross income ("MAGI") over certain thresholds
- The MAGI threshold for individuals is (i) $250,000 in the case of a joint return or surviving spouse, (ii) $125,000 in the case of a married individual filing a separate return, or (iii) $200,000 in any other case
- The new tax on NII (the "NII Tax") is a parallel to the Medicare hospital tax under FICA and SECA, which increased to 3.8 percent on January 1, 2013
- The tax is subject to the individual estimated tax provisions and is not deductible in computing any tax imposed by subtitle A of the Code
- The NII Tax will also apply to the lesser of a trust or estate's undistributed net income or the excess of the trust or estate's adjusted gross income (as defined in IRC §67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins
- Effective for taxable years beginning on or after January 1, 2013

Temporary Reduction of the S Corp BIG Tax

- The American Taxpayer Relief Act of 2012 includes a provision that shortens the S Corporation BIG tax recognition period from 10 years to five years for purposes of determining net recognized built-in gain during tax years beginning in 2012 and 2013. (See § 1374.)

- *Example* –Corporation X converted from C to S corporation status effective January 1, 2008. The Corporation has not subsequently acquired any assets from C corporations in carryover basis transactions. For the Corporation’s tax years beginning in 2012 and 2013, the recognition period is the five-year period that began January 1, 2008, and that ended December 31, 2012. Thus, the S corporation would be subject to the BIG tax on net recognized built-in gain in 2012; however, it would not be subject to the BIG tax on net recognized built-in gain in 2013. Absent additional legislation, the corporation would be subject to BIG tax on net recognized built-in gain in 2014, 2015, 2016, and 2017 (i.e., because the recognition period reverts to 10 years after the tax year that began January 1, 2013).

BASIC TAXABLE PARTNERSHIP ACQUISITION STRUCTURE

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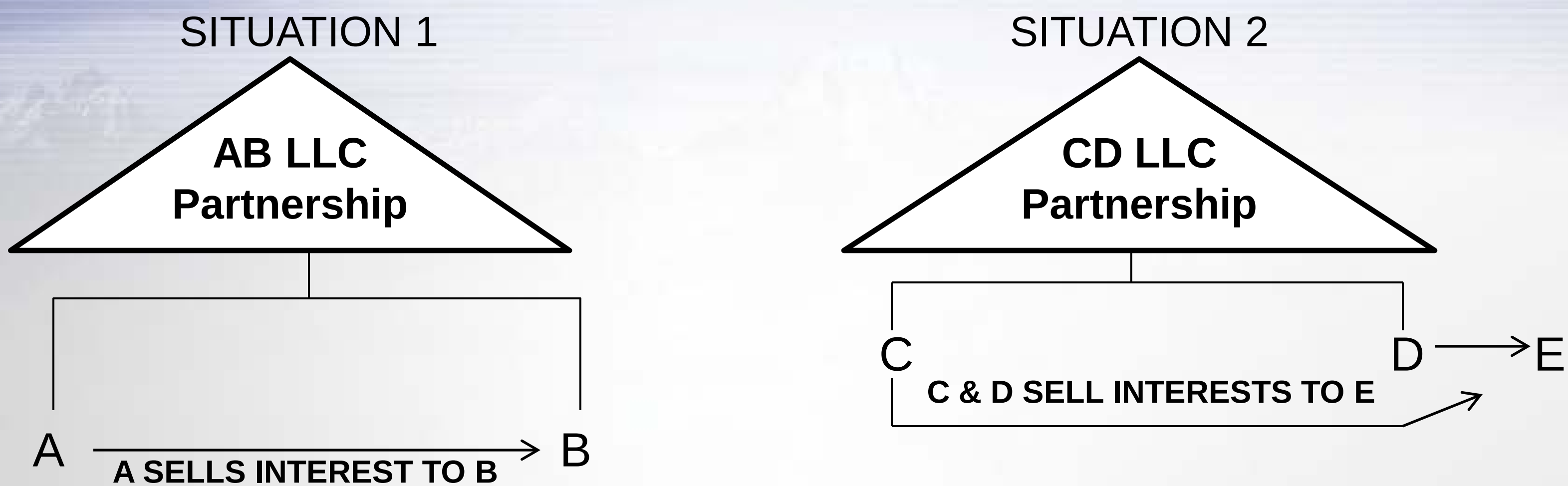
Basic Partnership Acquisition Structure (RR99-6)

- Rev. Rul. 99-6



  - Selling partners treated as selling partnership interests
  - Buyer treated as buying assets
  - Only Buyer Needs to file Form 8594 to allocate basis
  - Sellers recognize capital gain except for “hot assets”

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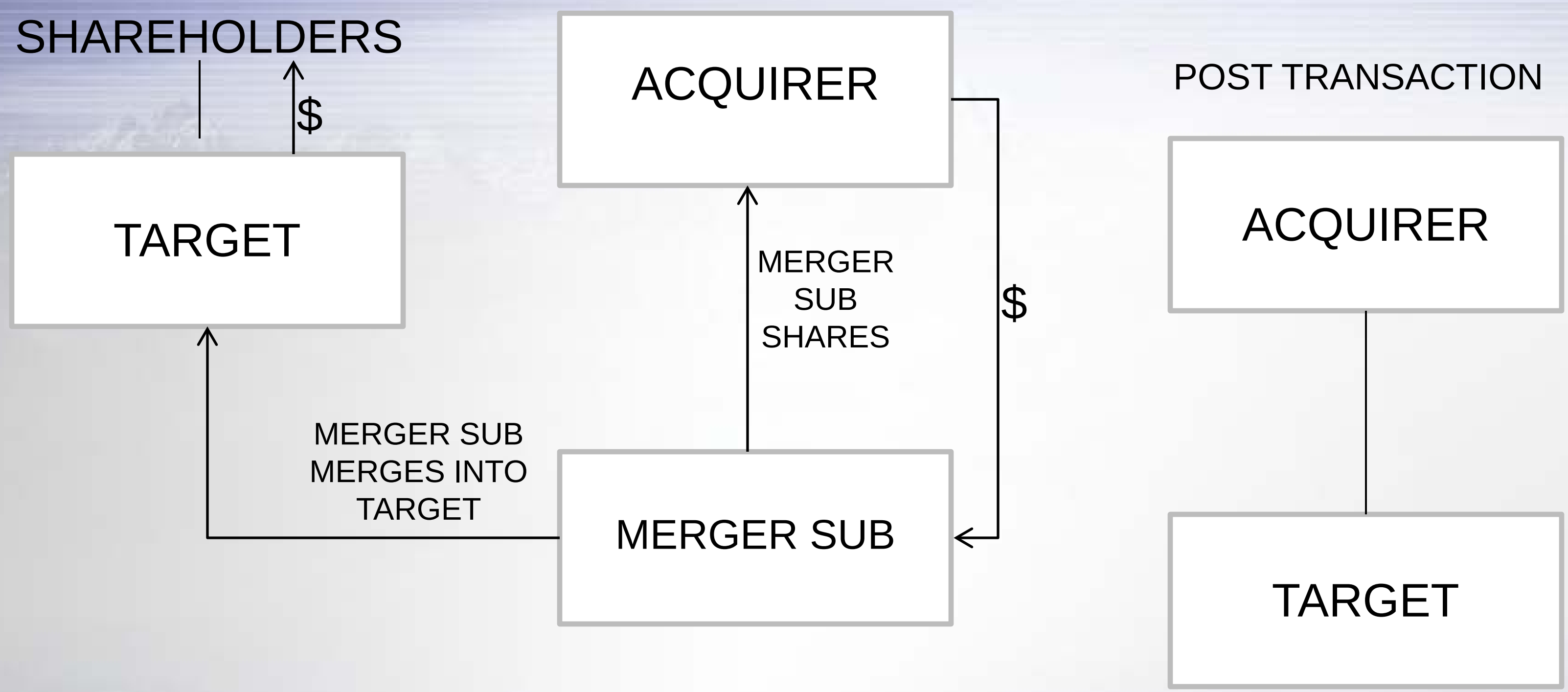
BASIC TAXABLE STOCK ACQUISITION STRUCTURE

REVERSE CASH SUBSIDIARY MERGER



Tax Consequences Of Reverse Cash Merger

- Treated as a taxable stock acquisition. Rev. Ruls. 73-427; 67-448
- No basis step up of Target assets (absent a 338 election)
- Treatment of Option holders
  - Vested in the money options typically paid out at closing based on merger share price
  - Option holders receive compensation income
  - Strategies for avoiding compensation: anticipatory exercise of options
  - Who gets the tax deduction where Target Corp joins Acquiring's consolidated group
    - AM 2012-010 concludes that accrual method Seller (<u>not</u> Buyer) gets the deduction.

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Section 338(h)(10)

- This subsection allows for a step up in basis of Target's Assets in a Qualifying Stock Purchase (which includes most reverse cash mergers)
  - Applies to taxable acquisitions of S corporations and members of an affiliated group
  - Transaction is treated as if Target sold all of its assets to Buyer and liquidated
  - Results in one level of tax (subject to BIG Tax/1374 for certain S Corps) and an inside basis step up of Target's assets
  - Requires a joint election by Buyer and Target stockholders made within 9 months of closing

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Section 338(h)(10) continued

- Requirements:
  - Must Be a Qualified Stock Purchase (“QSP”). At least 80% of Target’s stock must be acquired by “purchase”—no portion of that 80% must have in whole or in part a carryover basis, such as arising in a Section 351 or a reorganization transaction
  - If any portion of the acquisition is funded by debt secured by Target’s assets after closing, then the amount of the debt will be treated as if Target redeemed its stock and this amount will not be part of the stock “purchased.” See Rev. Rul. 78-250, PLR 8539056. The stock deemed redeemed will decrease the amount of Target stock considered outstanding for purposes of the 80% purchase requirement.

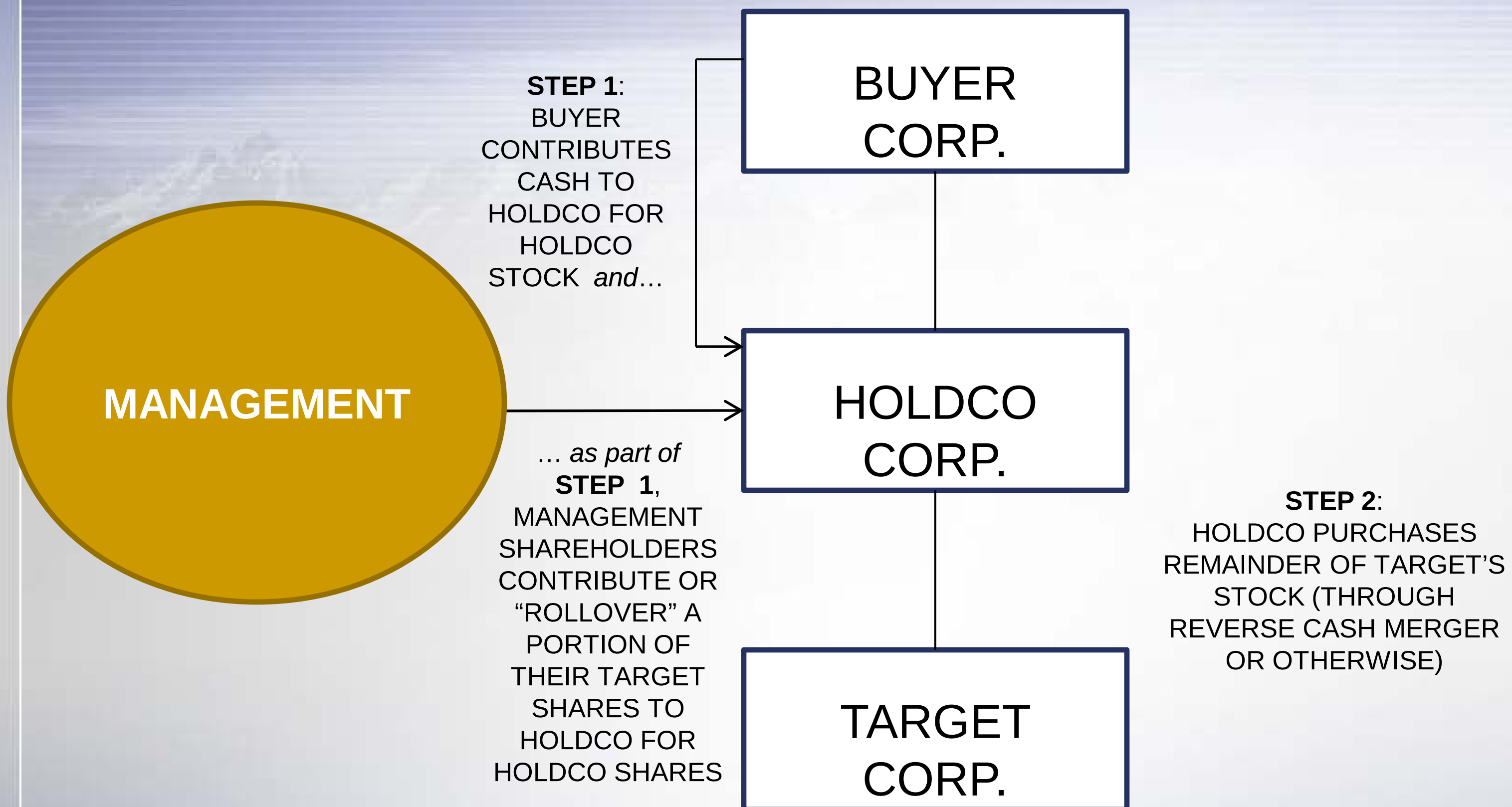
MANAGEMENT ROLLOVERS

Management Rollovers on Taxable Stock Acquisitions

- Often in private equity acquisitions Buyers want management to continue, or “rollover,” their equity stake in the target post-acquisition
- Rollovers are typically done on a pre-tax basis but sometimes after-tax, such as in 2011 and 2012 when there was and is an anticipation of soon-to-be increased capital gains rates
- Non-qualified preferred stock cannot be received tax-free under Section 351(g)
- Best practice is to use a contribution agreement to reflect rollover

Management Rollovers Intentionally Invoking 351

- Rollovers



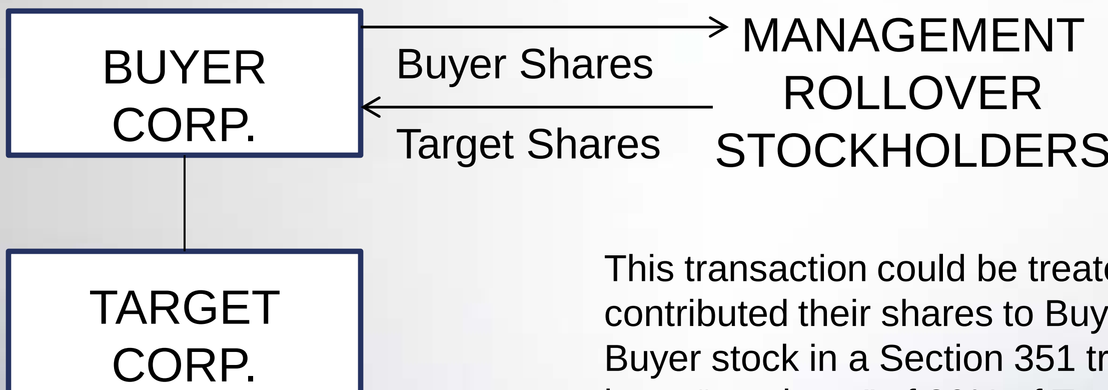
Under Section 351(a), management stockholders should recognize no gain on contribution to Holdco if contribution is part of one overall transaction with Buyer’s contribution of cash to Holdco.

Management Rollovers/S Corps/ 338(h)(10)

- Special consideration in S corp. rollover transactions:
  - Stock rolled over is not stock deemed to be “purchased.”
  - The rollover will be taxable and cannot be tax-deferred. See Treas. Reg. § 1.338(h)(10)-1(d)(5); -1(e) Ex. 10(vii).
  - The management rollover stockholder takes a stepped up basis in the Holdco stock received. Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii).
  - To avoid Holdco from recognizing gain in the Target rollover stock, such stock should be contributed to Holdco one day after the acquisition. Treas. Reg. §§ 1.338-5(d); 1.338(h)(10)-1(d)(1).

Management Rollovers/The 351 Trap If 338(h)(10) is Desired

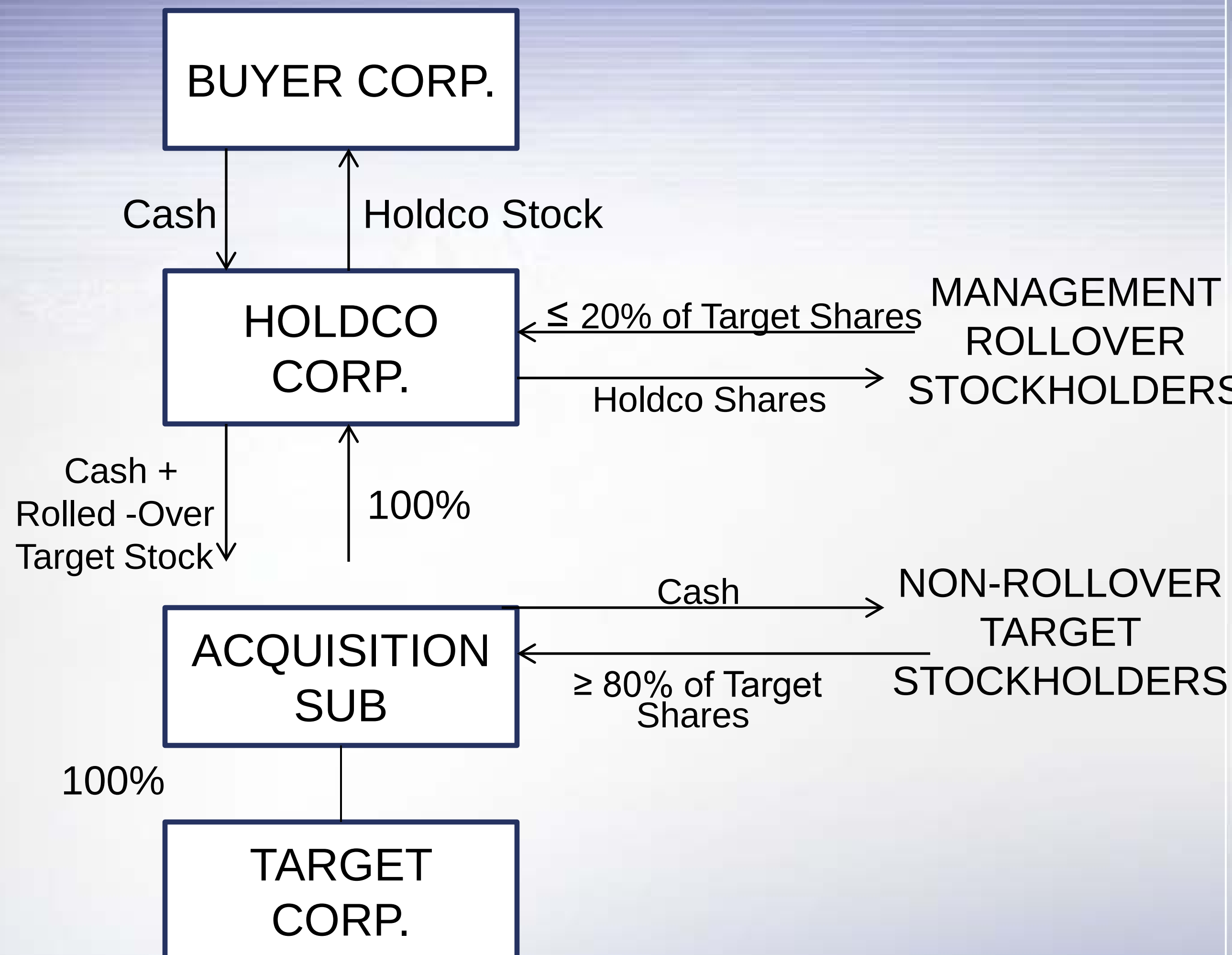
- Special considerations continued:
  - To avoid the rollover transaction being treated as a Section 351 transaction with boot under Section 351(b) and thus tainting the “purchase” requirement under 338(h)(10), Buyer should make the purchase through a wholly owned subsidiary rather than directly.



This transaction could be treated as if all Target stockholders contributed their shares to Buyer in exchange for cash and Buyer stock in a Section 351 transaction which would not be a “purchase” of 80% of Target; in that case Section 338(h)(10) would not apply

Management Rollovers/338(h)(10)/351 Trap

Solution: use an acquisition subsidiary which purchases at least 80% of Target stock; Section 351 should not apply to the stock purchased by Acquisition Co.



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Management Rollovers/338(h)(10) Trap

- If the rollover is too large in amount expressed as a percentage of Target’s equity, which will be adjusted by a deemed redemption addressed above, it may not be possible to make a 338(h)(10) election. For example, if there is a 30% rollover there can be no purchase of 80% of Target’s stock. Similarly, if there is debt causing a redemption of 20% of Target’s stock (reducing the stock to 80% of its total) and a rollover of a remaining 25% (20% of the original amount), there can be no purchase (because stock purchased is only 75% after redemption).

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Management Rollovers/338(h)(10) Trap

- Simple rule is that purchased stock must be at least 4 times the value of stock rolled over (after any redemptions)
- Solutions:
  - Convert Target to a single member LLC before closing, which should be treated as a taxable liquidation of Target followed by an asset purchase; possible liquidation-reincorporation risk
  - Merge Target into a wholly owned subsidiary of Buyer, which should be treated as an asset purchase under Rev. Rul. 69-6 and PLR 200628008
  - Rev. Rul. 84-44 (below)

BASIC CORPORATE REORGANIZATION STRUCTURES

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- General Requirements
  - Continuity of Interest
    - The historic stockholders of Target must receive substantial equity in Acquiring
    - A 40% equity interest is probably "substantial" in the A reorg context; See John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935)
  - Continuity of Business Enterprise
    - Acquiring must continue at least one of Target's significant businesses or use Target's business assets in a business
  - Business Purpose
    - Must be a legitimate business purpose, apart from reducing tax liability

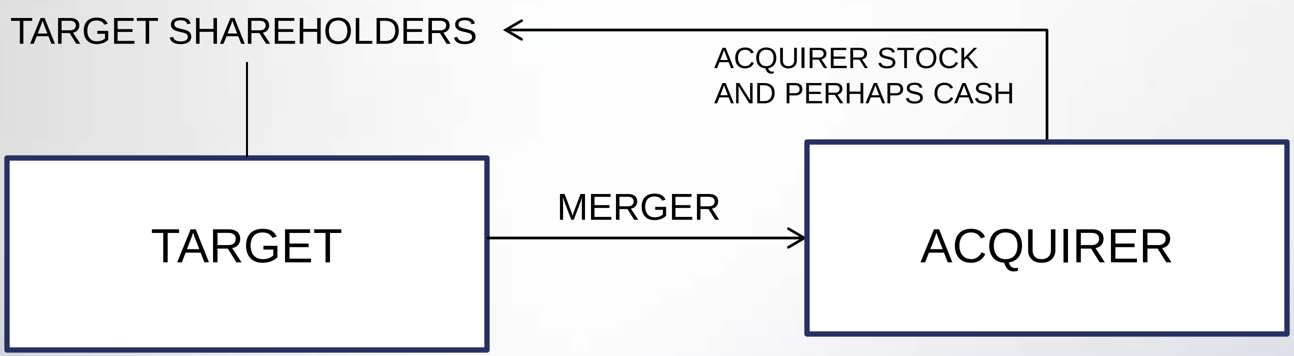
Reorganizations continued

- A Reorganizations

  State law merger, must satisfy the general requirements for such

  – Target shareholders recognize no gain except to the extent of any money and the fair market value of any other boot received (possible dividend)

  – Target shareholders’ basis in Acquirer stock is equal to their basis in their Target stock increased any gain recognized and decreased by any boot received and liabilities assumed.



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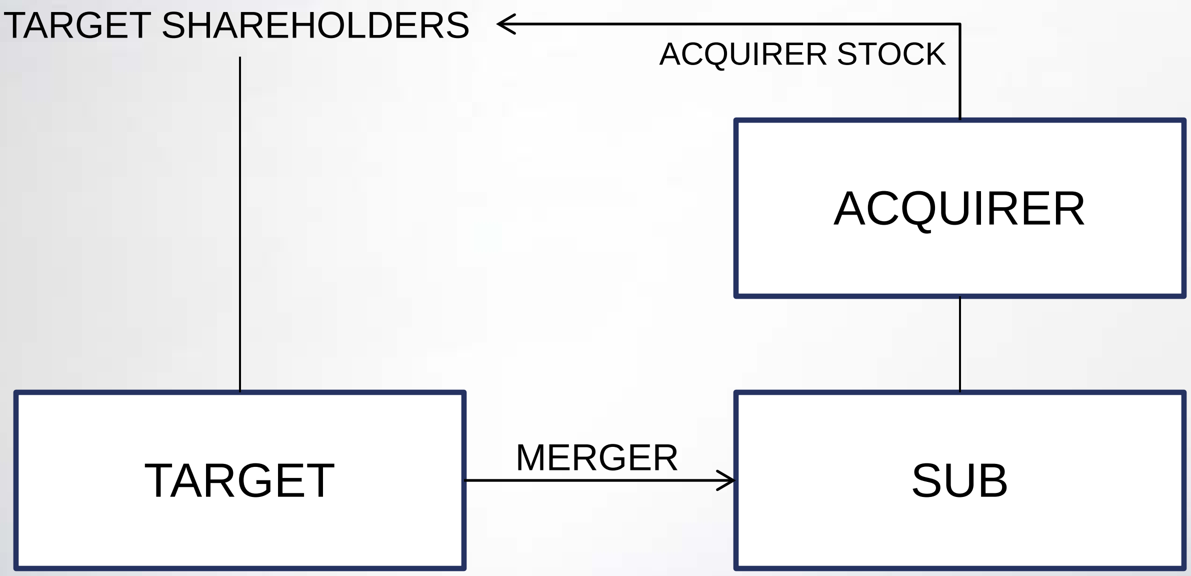
Reorganizations continued

- Triangular A Reorganizations
  - Sub must be 80% or more controlled by Acquirer
  - Sub must acquire substantially all of Target's assets
  - The stock received by Target shareholders must be Acquirer stock (as opposed to Sub stock).



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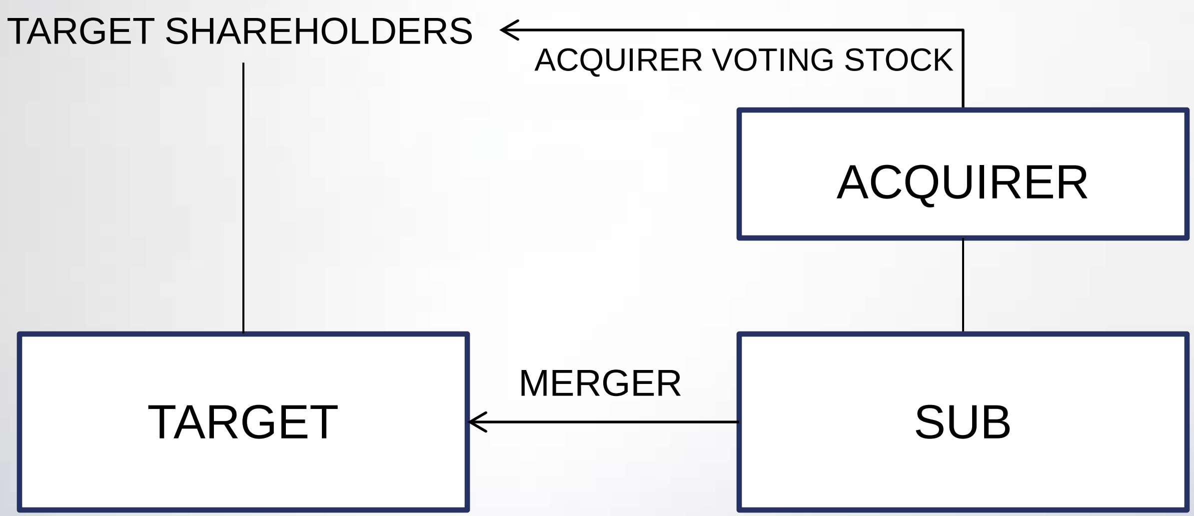
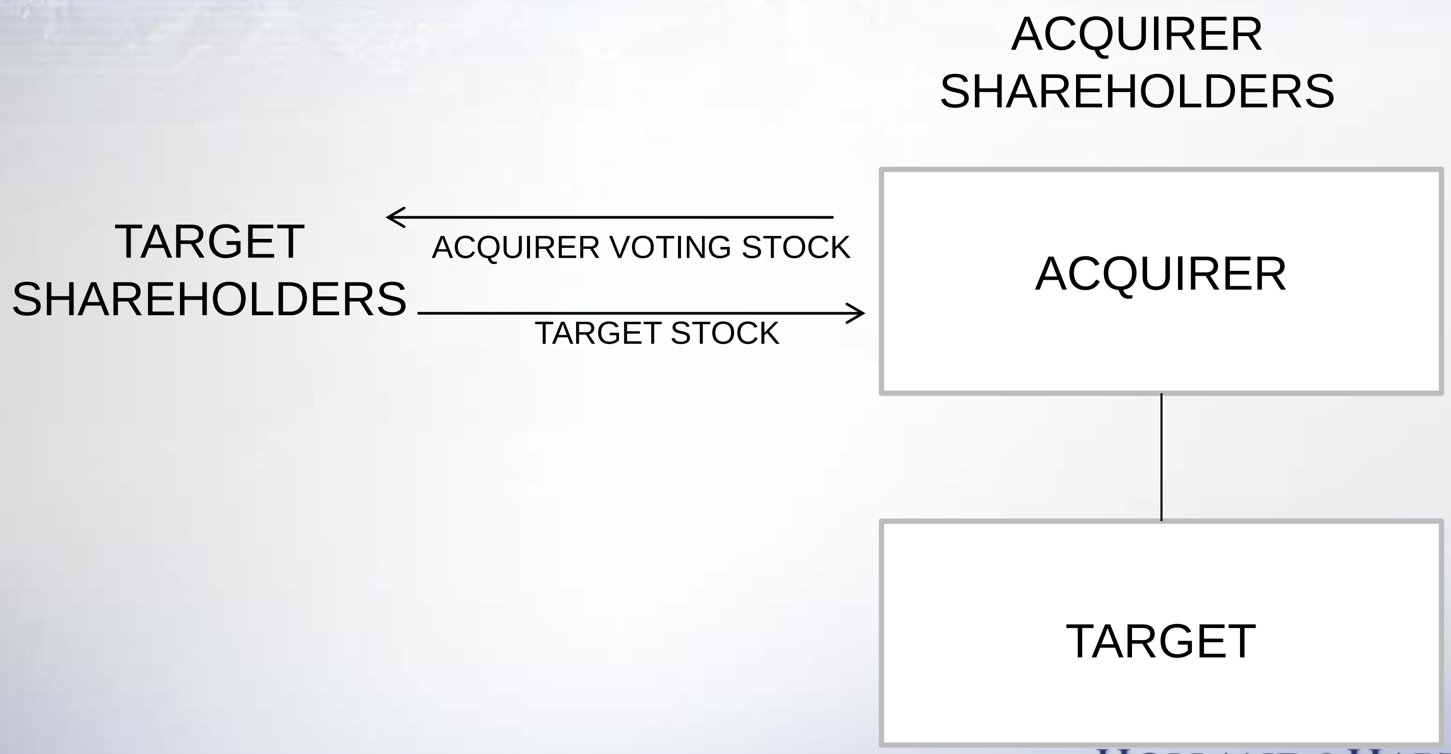
Reorganizations continued

- Reverse Triangular Merger
  - After the transaction, Target holds substantially all of its properties and the properties of Sub (other than stock of Acquirer distributed in the transaction)
  - In the transaction, former shareholders of Target exchanged, for an amount of voting stock of Acquirer, an amount of stock in Target which constitutes control (80%)



Reorganizations continued

- B Reorganizations
  - Acquirer must acquire at least 80% control of Target in exchange solely for voting stock of Acquirer

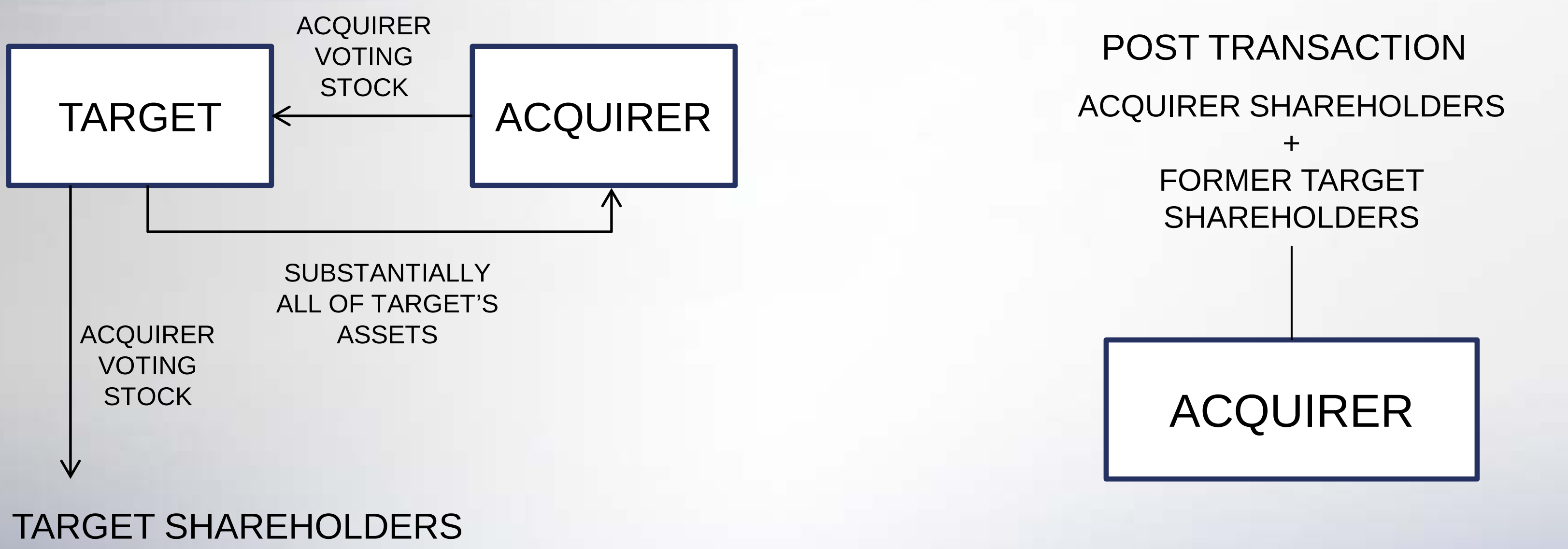


Reorganizations continued

- C Reorganizations

  -- Acquirer must acquire substantially all the assets of Target in exchange for voting stock of Acquirer and Target must liquidate

  -- If Acquirer acquires at least 80% in fair market value of Target’s assets for voting stock the use of money or other property in addition to voting stock will not disqualify the transaction (for this purpose liabilities assumed are treated as money paid)



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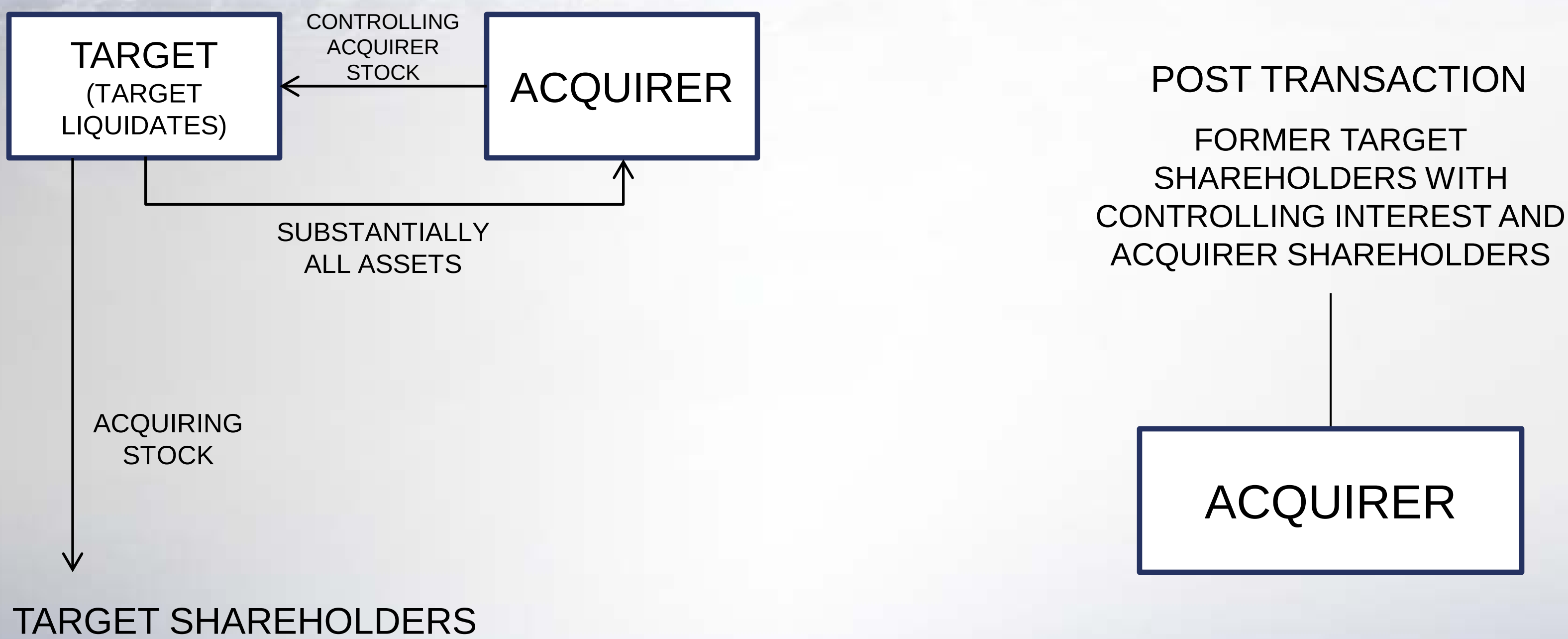
Reorganizations continued

- D Reorganization
  - Acquirer must acquire substantially all of Target's assets
  - Immediately after the acquisition, Target and/or its Shareholders must control Acquirer
  - Acquirer must distribute stock or securities under Sections 354, 355 or 356



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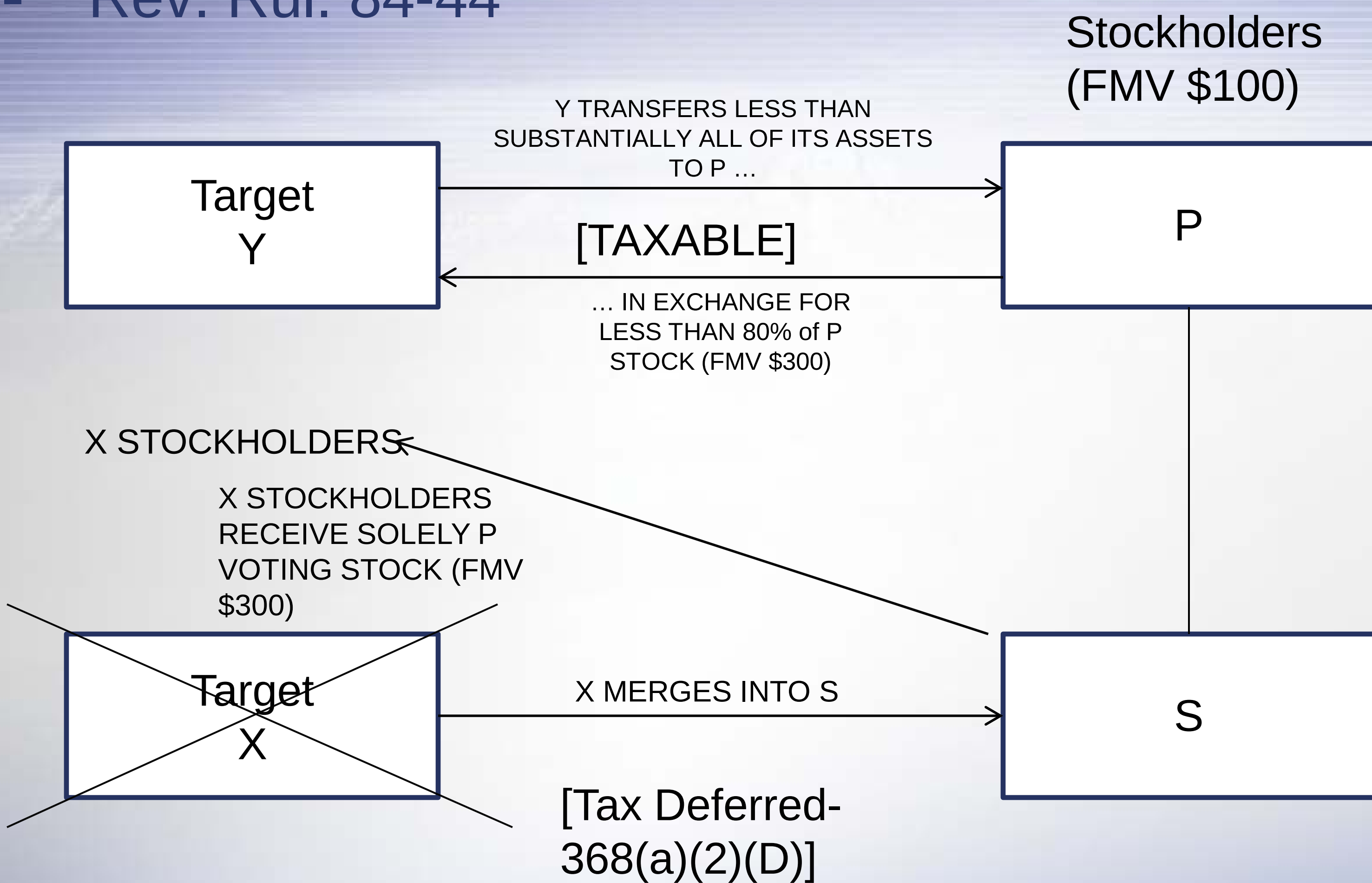
Reorganizations continued

- Other Reorganizations
  - Type E
    - Recapitalizations
  - Type F
    - A mere change in identity, form, or place of organization of ***one corporation***
  - Type G
    - A transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case, but only if, in pursuant of the plant, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section 354, 355, or 356.

TURNING "ON" OR "OFF" SECTION 351

Turning “On” or “Off” Section 351

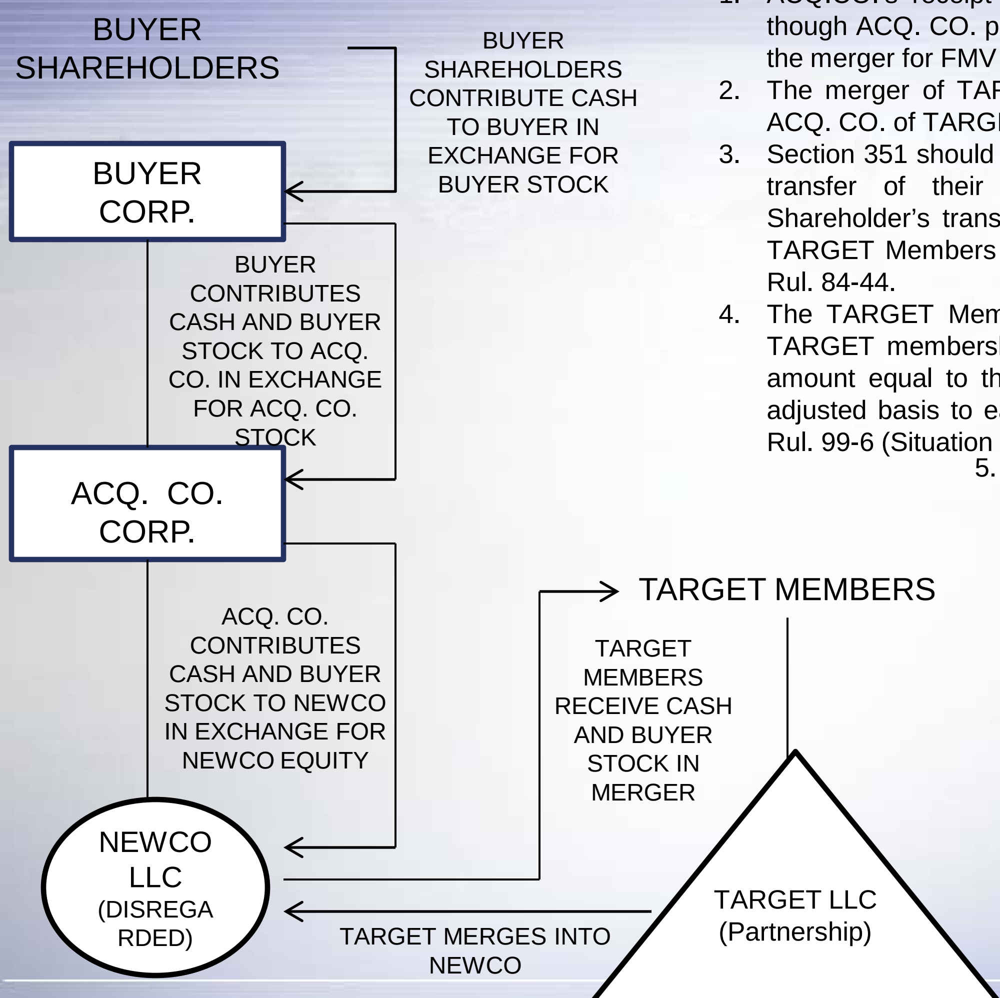
- Rev. Rul. 84-44



Turning “On” or “Off” Section 351

- Rev. Rule 84-44 holds that Y is taxable on the asset transfer to P because (1) Y was not in “control” of P after the transfer and (2) the merger of X to S is not deemed to be a contribution of property to P, and thus Section 351 does not apply to aggregate X’s transfer with Y’s transfer for purposes of Section 531.
- Note: In Rev Rul. 84-44, if S had merged into X (rather than X into S), then the X shareholders would have been included in the “control” group for purposes of testing under § 351. *See e.g.*, PLR 201222014.

Turning off 351/Corp. Acquisition of Partnership



1. ACQ.CO.'s receipt of BUYER stock for NEWCO equity is treated as though ACQ. CO. purchased BUYER stock for cash immediately prior to the merger for FMV under Section 1032.
2. The merger of TARGET into NEWCO is treated as an acquisition by ACQ. CO. of TARGET's assets.
3. Section 351 should not apply so as to characterize the Target Member's transfer of their TARGET interests together with the BUYER Shareholder's transfer as a tax free Section 351 transfer because the TARGET Members did not transfer any property to BUYER. See Rev. Rul. 84-44.
4. The TARGET Members must treat the transaction as a sale of their TARGET membership interests and must recognize capital gain in an amount equal to the difference between the amount realized and the adjusted basis to each member of his membership interest. See Rev. Rul. 99-6 (Situation 2).
5. Under Section 751, if TARGET has any unrealized receivables or inventory (so called, "hot assets") gain or loss attributable to such hot assets will be treated as ordinary income.

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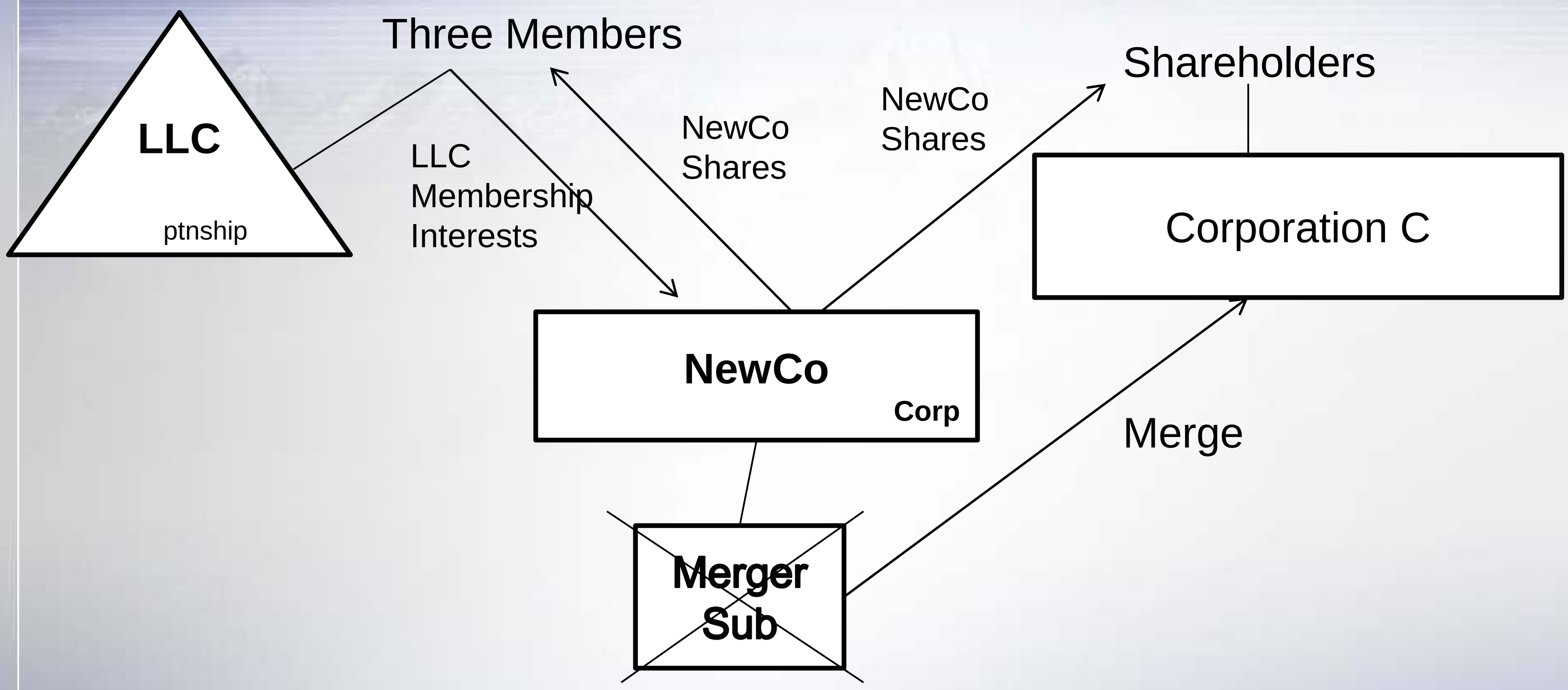
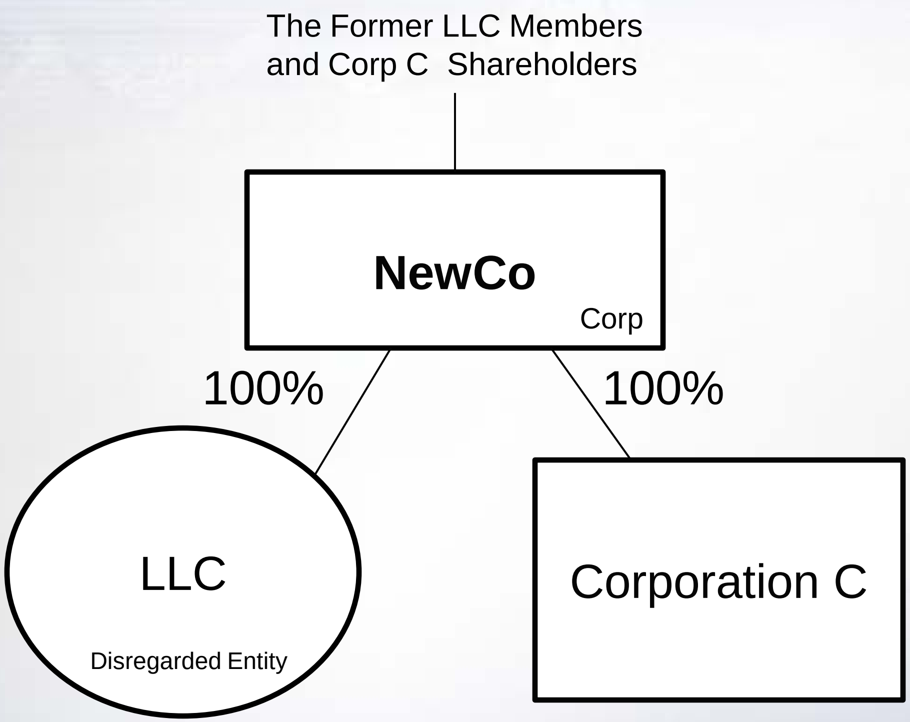
Turn On 351/Corp. Acquisition of Partnership

Large Company Acquisition of (combination with) LLC in 351 Transaction PLR201222014)



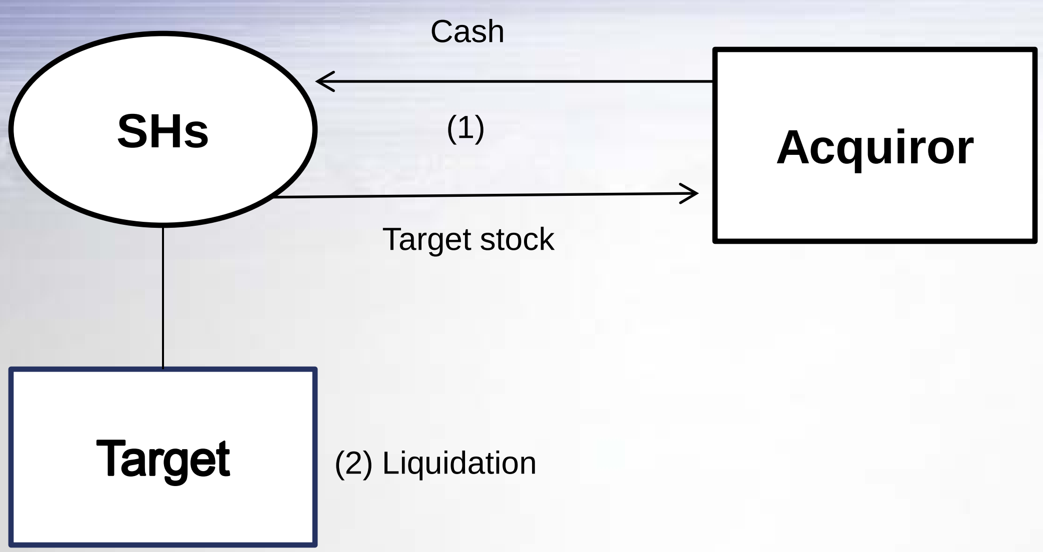
Turn on 351/Corp. Acquisition of Partnership

Corporate Acquisition of (combination with) LLC in Tax Deferred Transaction



WATCH OUT FOR STEP TRANSACTION OR SUBSTANCE OVER FORM TREATMENT

The Step Transaction Doctrine does not Apply to a Taxable Stock Purchase Followed by a Liquidation of Target

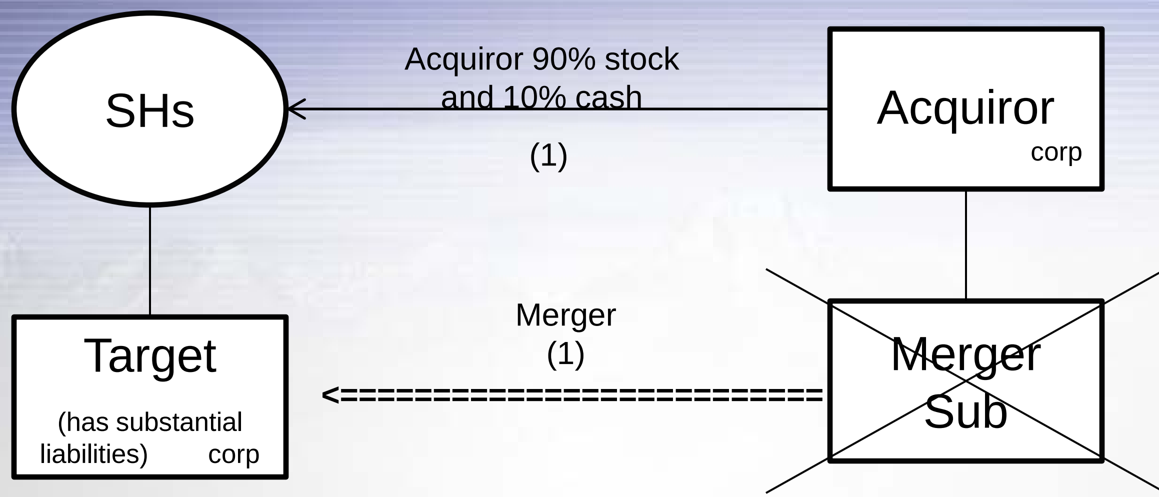


QSP + Liquidation of Target =

- Separate steps are respected;
- No asset level gain or step-up

Rev. Rul. 90-95. See also Treas. Reg. §1.338-3(c)(1)(i) and Treas. Reg. §1.338-3(d).

A Second-Step Liquidation Can Transform an Otherwise Good First-Step Reorganization into a Taxable Stock Purchase.



(2) State law liquidation or Target into Acquiror

Reverse Triangular Merger (not by itself as QSP) + Liquidation of Target = Taxable Stock Purchase Plus Tax-Free Liquidation

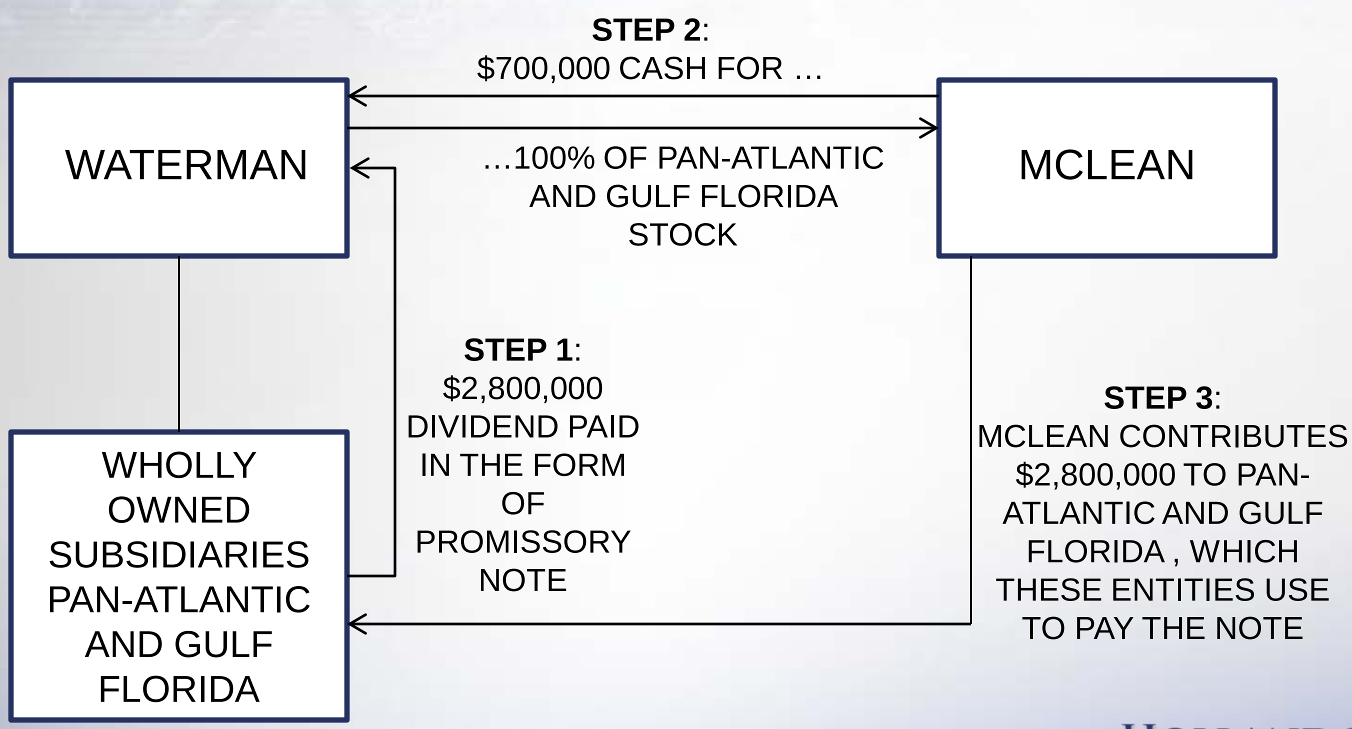
Revenue Ruling 2008-25 applies the step transaction doctrine to find that the integrated transaction does not qualify as a reorganization. The “turn off” of the step-transaction doctrine under Treas. Reg. §1.368-2(k) does not apply because Target is completely liquidated. Because integration would result in a taxable asset acquisition and violate the policy underlying Section 338, Rev. Rul. 2008-25 treats Steps (1) and (2) as a separate QSP and tax-free liquidation.

Planning Point: Target Shareholders should obtain a representation from Acquirer that it has no plan or intention to liquidate Target.

Use of Target Cash/Unwanted Assets

- Use of Target's Cash to Fund the Acquisition

<u>Waterman Steamship Corporation v. Commissioner</u>, 430 F.2d 1185 (5th Cir. 1970)



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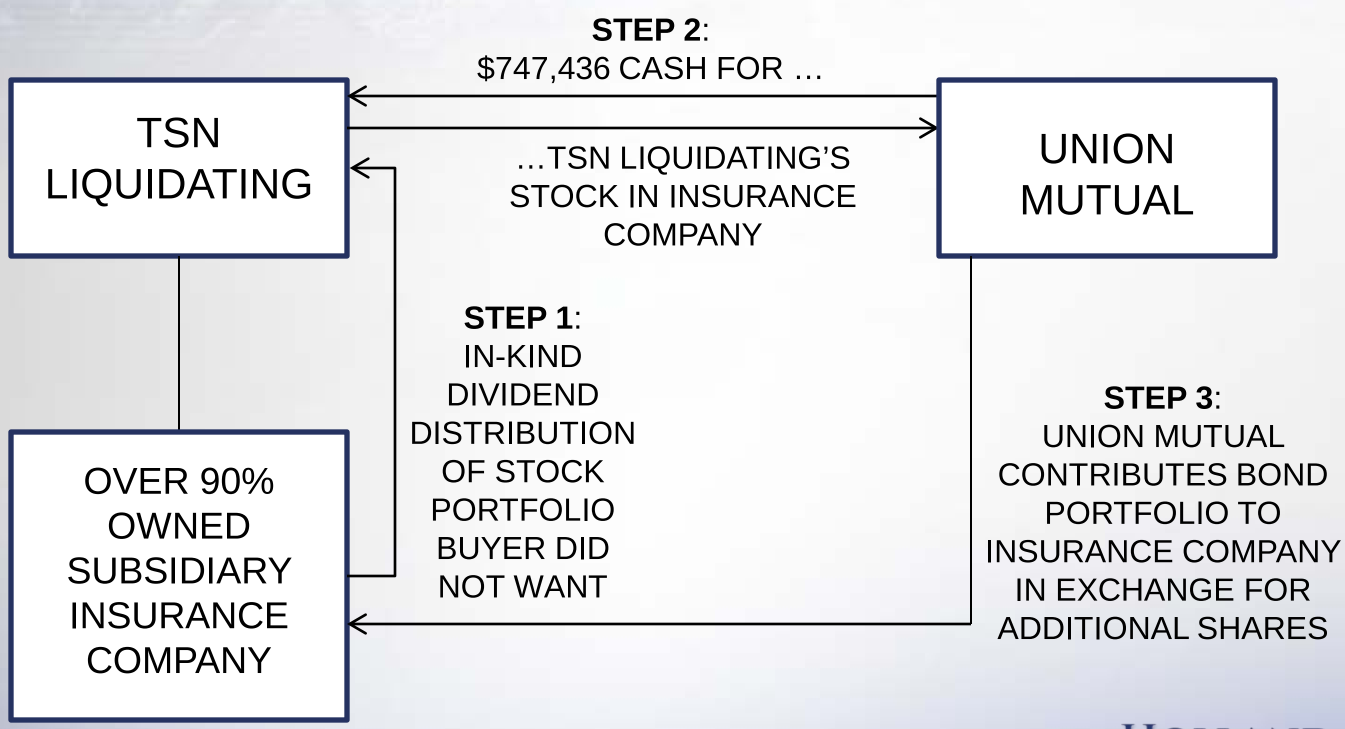
Unwanted assets continued

- Seller's tax basis in the stock of the subsidiaries sold was $700K and dividend was eliminated from income under the consolidated return regulations
- IRS argued substance over form. Original price was $3.5 million
- Appeals court held that where buyer supplied the funds for the dividend and the dividend was part of one overall sale transaction, the distributing subsidiary was a mere conduit for the transfer of sales proceeds
- Seller taxable on the entire $3.5 million sale price
- Consolidated Return Regulations were amended after Waterman Steamship to effect basic reduction equal to the distribution . . . But still an opportunity if Target and Target Shareholders do not file consolidated return.

Unwanted assets continued

<u>TSN Liquidating Corporation, Inc. v. U.S.</u>, 624 F.2d 1328 (5th Cir. 1980)



Unwanted assets continued

- Buyer did not want to buy assets distributed and did not pay for them
- Seller claimed 85% dividends received deduction on the distribution of assets
- <u>Waterman</u> distinguished
- <u>See</u> Rev. Rul. 75-493, holding that a pre-closing distribution was a dividend, because the distribution did not reduce the amount of the purchase price, and distributing corp. had sufficient E&P to result in a dividend

EARN OUTS

Earn Outs

- Earn outs are typically used when Buyer is uncertain of the actual value of the Target enterprise and is reluctant to pay Seller's price; it is a way to hedge against making a bad deal
- Tax on earn out consideration can be deferred under the installment sale rules
- If Target stockholders continue to be employed by Target or Buyer after the closing and payment of earn out is contingent on continued employment, earn out will likely be treated as compensation income rather than capital gain on sale of stock

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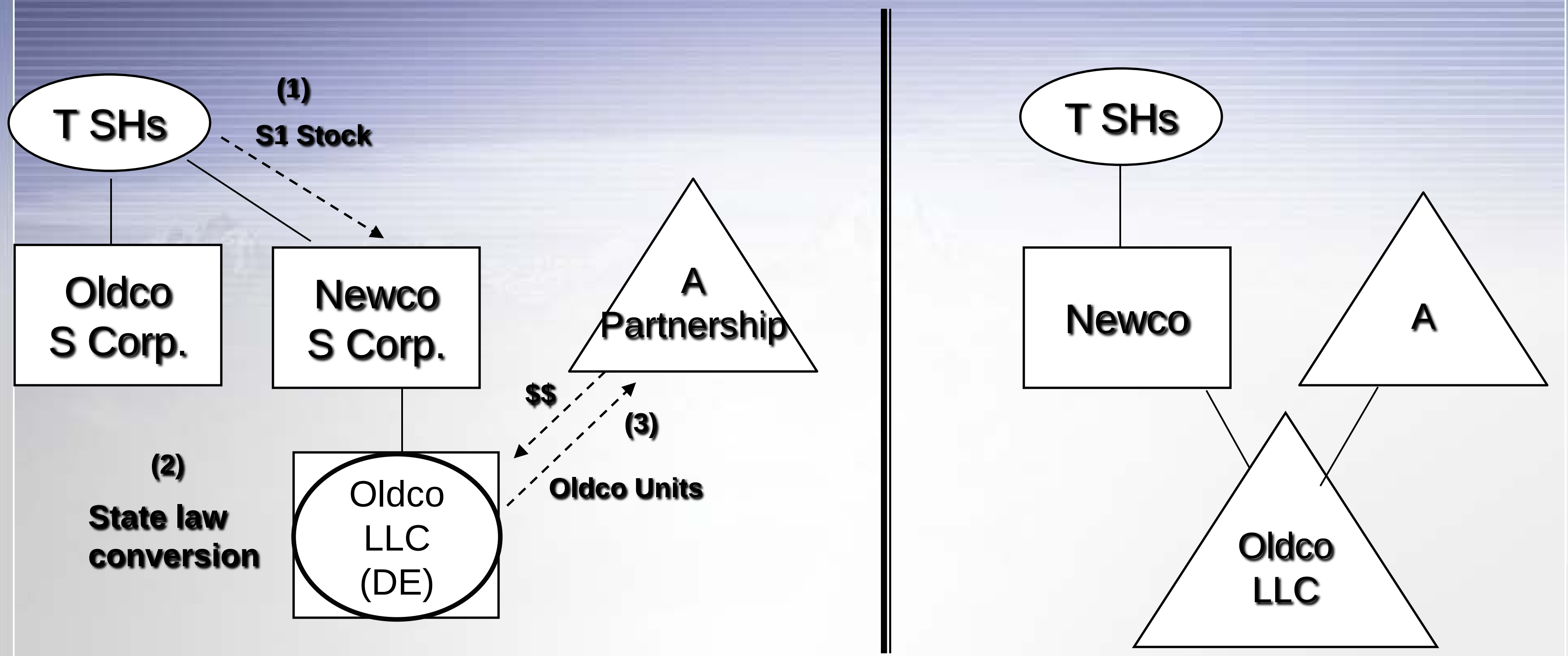
USING "F" REORGS. TO PRESERVE S ELECTION AND AVOID STATE LAW TRANSFER IN PRIVATE EQUITY INVESTMENT OR ACQUISITION

Basic F Reorganization to Avoid State Law Asset Transfer and to Preserve Pass Through Treatment



- Basic F reorganization: Oldco S/Hs form Newco; Oldco S/Hs contribute Oldco to Newco; Oldco is converted into an LLC under state law.
- A invests directly into Oldco, resulting in deemed formation of a partnership for tax purposes.
- Allows Oldco's assets to be transferred to a partnership for tax purposes while avoiding a transfer of the assets under state law.
- Also, if Oldco is an S corporation, allows investment in Oldco by a corporation or non-resident individual or issuance of "second class of stock" of Oldco while preserving S status at Newco level.

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ESOPs As An Exit Strategy

<u>Leveraged ESOPs: There are Four Principal Tax Incentives to Use Them</u>

- Section 1042 capital gains deferral for non-C-corporation sellers of nonpublic C corporations
- Effective deduction of ESOP loan <u>interest and principal</u>
- Deduction of dividends paid on ESOP-held shares (C Corporations) (but not for corporate AMT)
- S Corporation ESOP: flow-through of corporate income to ESOP shareholder – no corporate-level tax – and ESOP trust (a tax-exempt entity) shareholder pays no shareholder-level tax

ESOPs As An Exit Strategy (cont'd)

What are the Mechanics of a leveraged ESOP Transaction?

- Company establishes an ESOP and an ESOP Trust
- Bank and/or sellers provide "traditional" outside financing to Company ("outside loans")
- Other "capital markets," players can be non-traditional outside financing sources to Company: PEGs, mezzanine investors, private investors (in the form of other "outside loans" and warrants), other qualified plan balances
- Company lends money received from outside sources and/or its own funds to ESOP (exempt "inside loan")
- ESOP Trust purchases Company stock from shareholders or from Company

ESOPs As An Exit Strategy (cont’d)

What are the Mechanics of a leveraged ESOP Transaction? (cont’d)

- Stock purchased by the ESOP with the “inside loan” is held in a suspense account within the ESOP
- Company pays deductible contributions and/or deductible dividends to ESOP that ESOP uses to repay “inside” loan debt from Company
- As the “inside loan” is repaid, shares in the ESOP are released from the suspense account to ESOP employee accounts
- Company repays bank and other outside loans, in effect with before-tax dollars
- Company or ESOP repurchases shares from employees after employment terminates at the then FMV – therefore Company must plan for repurchase obligation funding
- An ESOP itself may be a seller or a buyer in a capital markets “exit” (or may remain as the sole shareholder after a capital markets redemption “exit”)

Conclusion and Questions

THANK YOU

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